

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2012)	
)	Docket No. ACR2012
)	

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2012 ANNUAL COMPLIANCE REPORT
(February 1, 2013)**

William J. Olson
Jeremiah L. Morgan
John S. Miles
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc.
and Valpak Dealers' Association, Inc.

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INTRODUCTION

On December 28, 2012, the United States Postal Service ("USPS") filed its "United States Postal Service FY 2012 Annual Compliance Report" ("ACR"), which is required by 39 U.S.C. section 3652(a) to be filed within 90 days after the end of fiscal year 2012. On January 2, 2012, the Postal Regulatory Commission ("Commission") issued Order No. 1609, "Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments," seeking initial comments by February 1, 2013, and reply comments by February 15, 2013. The Commission's Annual Compliance Determination ("ACD") is expected in late March 2013, pursuant to 39 U.S.C. section 3653(b).

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint initial comments in response to the Commission's Notice.

COURSE OF PROCEEDINGS

The Commission issued Order No. 1609, commencing proceedings in this docket, and inviting:

public comment on the Postal Service's FY 2012 ACR and on whether any **rates or fees in effect during FY 2012** (for products individually or collectively) were **not in compliance** with applicable provisions of chapter 36 of title 39 (or regulations promulgated thereunder). Commenters addressing market dominant products are referred in particular to the applicable **requirements** (39 U.S.C. 3622(d) and (e) and 3626); **objectives** (39 U.S.C. 3622(b)); and **factors** (39 U.S.C. 3622(c))....

The Commission also invites public comment on the **cost coverage matters the Postal Service addresses in its filing**; service performance results; levels of customer satisfaction achieved; progress toward goals established in the annual Comprehensive Statement; and such other matters that may be relevant to the Commission's review. Comments on these topics will, *inter alia*, assist the Commission in developing appropriate recommendations to the Postal Service related to the protection or promotion of the **public policy objectives** of title 39. [Order No. 1609, p. 5 (emphasis added).]

On January 15, 2013, Valpak filed a Motion for Issuance of Information Request, seeking additional information related to Standard Mail Flats. On January 18, 2013, the Commission incorporated Valpak's requests into Chairman's Information Request ("ChIR") No. 4. *See* ChIR No. 4, questions 1-3.

I. THE POSTAL SERVICE IS SUFFERING SUBSTANTIAL ANNUAL OPERATING LOSSES WHICH JEOPARDIZE ITS FINANCIAL STABILITY, REQUIRING THE COMMISSION TO ACT DECISIVELY.

Consistent with what it has done in prior years, the Postal Service's FY 2012 Annual Compliance Report itself contains no new commentary discussing, or even describing, the financial health of the Postal Service. This is unfortunate, as the Postal Service has never been in worse financial condition. The Postal Service's financial crisis cannot be overlooked by the Commission, as one of the key objectives of the Postal Accountability and Enhancement Act ("PAEA") is "[t]o assure adequate revenues, including retained earnings, to maintain financial stability." 39 U.S.C. § 3622(b)(5). The Postal Service clearly has failed to achieve this objective under PAEA. Rather than providing a current narrative for the Commission to consider as a backdrop for the report, the Postal Service appends, as required, as library references a variety of documents which contain an avalanche of raw information about its financial condition, including:

- FY 2012 Annual Report to Congress
- FY 2012 Comprehensive Statement on Postal Operations
- FY 2012 Annual Performance Report and FY 2013 Performance Plan
- FY 2013 Integrated Financial Plan

Additionally, the Postal Service relies on documents previously filed with the Commission, such as its U.S. Postal Service FY 2012 Form 10-K (Oct. 15, 2012) ("USPS FY 2012 10-K").

The following comments seek to analyze these source documents in an attempt to give a real world context for the Commission's Annual Compliance Review, with particular focus on the Postal Service's failure to achieve objective (b)(5), and the current jeopardy to self-supporting operations of the Postal Service.

A. PAEA's Requirement for Postal Service Pre-funding of the Retiree Health Benefit Fund Has Decimated Postal Service Finances.

Valpak's Comments on the Postal Service's FY 2011 ACR observed that:

[t]he Postal Service's financial condition was so **dire** at the end of FY 2011 that Congressional remedial action **will be required before the end of FY 2012**. [Valpak Initial Comments, Docket No. ACR2011, p. 3 (emphasis original).]

The portion of that statement describing the Postal Service's financial condition as "dire" has stood the test of time, but the prognostication regarding Congressional action underestimated Congress' propensity to avoid acting until action becomes absolutely unavoidable.

Congress has given no relief from the aggressive pre-funding schedule for the Postal Service Retiree Health Benefits Fund ("RHBF") imposed by PAEA. This unique burden imposed on the Postal Service has exhausted its retained earnings, maximized its statutory borrowing capacity, and forced two unprecedented defaults totaling **\$11.1 billion** now owed to the U.S. Treasury. Yet another default is in the offing, as the Postal Service does not expect to be able to pay the **\$5.6 billion** due Treasury by September 30, 2013. *See* USPS FY 2012 10-K, p. 41.

Although most press accounts of Postal Service finances focus on the **gross loss** that includes RHBF payments, the more important consideration is the Postal Service's **operating loss**, which is the focus of these comments. Table I-1, *infra*, shows Postal Service operating revenue and operating expenses for FY 2007 through FY 2012, the years following enactment of PAEA in December 2006. The first row shows **operating revenue**, all of which is derived from mailers, except for a few minor items. The second row shows all **operating expenses**, excluding retiree health benefits. Payments for health insurance premiums for **current**

retirees, which always have been recorded as an operating expense, are shown separately on row 4 of Table I-1.¹ The net profit or loss from **operations** is shown on row 5.

Table I-1
Postal Service Operating Revenue and Expenses
FY 2007 – FY 2012
(\$, millions)

	FY '07	FY '08	FY '09	FY '10	FY '11	FY '12
1. Operating Revenue	74,778	74,932	68,090	67,052	65,711	65,223
2. Operating Expenses, Ex-Retiree Health Benefits	<u>70,021</u>	<u>70,331</u>	<u>68,440</u>	<u>67,679</u>	<u>68,193</u>	<u>67,235</u>
3. Op. Profit (Loss) Before Retiree Health Benefits	4,757	4,601	(350)	(627)	(2,482)	(2,012)
4. Health Benefits for Current Retirees	<u>1,726</u>	<u>1,807</u>	<u>1,990</u>	<u>2,247</u>	<u>2,441</u>	<u>2,629</u>
5. Net Op. Profit (Loss), excluding RHBF	3,031	2,794	(2,340)	(2,874)	(4,923)	(4,641)
6. Funding of RHBF	8,358	5,600	1,400	5,500	-----	11,100
7. Six-year net operating loss , excluding RHBF						8,953
8. Six-year cost of RHBF						<u>31,958</u>
9. Six-year total reported loss						40,911

Sources: USPS FY 2012 10-K, p. 78; USPS FY 2011 10-K, pp. 80 and 89, n.7; and USPS FY 2009 10-K, pp. 63 and 71.

Outlays to fund **future** health benefits for future retirees are shown on row 6, where all entries through FY 2010 reflect cash payments to help fund the RHBF.² The \$11.1 billion

¹ This approach is referred to sometimes as a pay-as-you-go procedure. The cost of health insurance for current employees also is included in current operating expenses.

² Prior to PAEA, the Postal Service funded retiree health care costs on a **current** basis, but did **not prepay future** costs. The Postal Service's financial statements are required by generally accepted accounting principles ("GAAP") to include contributions to the RHBF as operating expenses because those outlays are statutorily mandated by PAEA.

entry on row 6 under FY 2012 was not paid; it was charged to expenses and is carried on the Postal Service's balance sheet as a current liability. Lesser amounts shown on row 6 in FY 2009 and FY 2011 reflect partial abatements allowed by Congress. *See* USPS FY 2012 10-K, p. 80.

For the six years shown in Table I-1, **cumulative losses** by source are summarized on rows 7-8. Of the total cumulative loss of \$40,911 million, **over 78 percent** was attributable to payments to the **RHBF**. Thus, Postal Service's **operating losses** have been dwarfed by aggressive funding of the retiree health benefits required by PAEA — a problem outside the Postal Service's control. However, **operating profits** are key, as without them the Postal Service will be unable to make any payments to the RHBF, to say nothing of the multi-billion dollar payments demanded by Congress. (Because of its importance, funding of the RHBF is the subject of separate discussion in Section I.I, *infra*.³) The large losses attributable to funding of the RHBF should not be used as a smokescreen to divert attention from the Postal Service's **core problem** — **operating losses** — which have been suffered for the last four years, and seem likely to continue for some time to come.

³ RHBF is also the subject of a recent study by GAO, *USPS: Status, Financial Outlook, and Alternative Approaches to Fund Retiree Health Benefits*, GAO-13-112 (Dec 2012) ("GAO RHBF Report"), <http://www.gao.gov/products/GAO-13-112>.

B. In FY 2012, the Postal Service Suffered a Net Operating Loss of \$4.6 Billion, Stabilizing a Downward Spiral, but Continued Losses Could Jeopardize the Postal Service’s Survival as a Financially Independent Entity.

Despite significant efforts, the Postal Service has been unable to reduce expenses fast enough or far enough to keep pace with the decline in mail volume and revenues. The extent of the Postal Service’s core problem can be seen in Table I-1. During the **first two years** under PAEA, the Postal Service actually had a cumulative net operating income, or operating “**profit,**” of **\$5.8 billion**, but at the end of the entire **six-year period** that initial profit gave way to huge losses, resulting in a cumulative operating **loss of almost \$9.0 billion** (*see row 7*). Expressed another way, the Postal Service has swung from a **two-year operating profit of \$5.8 billion**, to a **four-year operating loss of \$14.8 billion** — a rather spectacular downward spiral.

A major source of the problem is diversion of volume and revenue from highly profitable First-Class Mail. The decline accelerated during the recession in 2008, when mailers moved to cut costs dramatically. Since FY 2008, **operating revenues have declined by \$9.7 billion** (Table I-1, row 2). Over the same period, **operating expenses have been reduced, but only by \$3.1 billion**. The Postal Service deserves commendation for achieving those cost reductions, and it now has underway some long overdue and much-needed structural network reforms designed to achieve some reductions in operating expenses.

In FY 2012, the downward spiral in the bottom line slowed and showed signs of stabilizing around the current level. Operating expenses — excluding health benefit costs (Table I-1, row 2) — declined somewhat, but health insurance premiums for current retirees

(row 4) increased.⁴ The operating loss of \$4.6 billion reported in FY 2012 compares favorably with the \$4.9 billion operating loss reported in FY 2011 (row 5), but continued operating losses at that level could make the Postal Service non-sustainable rather quickly.

Some of the Postal Service's financial problems have been externally imposed, but the Postal Service itself has had a hand in creating those problems. Over the last **six years**, a **collection of loss-generating market dominant products and special services** failed to cover their attributable costs by over **\$8.1 billion**, despite the fact that PAEA gives the Postal Service considerable flexibility with respect to pricing. **Had the Postal Service avoided all losses on underwater products** during the last six years, it would have had a **cumulative loss from operations of only 1/10th of what it was — around \$900 million, instead of \$9.0 billion**. These underwater products are an integral part of the Postal Service's core problem. It is reasonable to infer that the Postal Service has failed to use its pricing flexibility to maximum advantage, thereby severely worsening its finances. Looking ahead, expected continuation of the financial hemorrhaging from underwater products is an important factor helping to perpetuate the Postal Service's core problem of operating losses.⁵ Underwater products are discussed in these Comments in Sections II-VI, *infra*.

⁴ As the Postal Service's labor contracts generally preclude layoffs, its labor force is being downsized gradually through attrition. The Postal Service estimates that half its current labor force is eligible for retirement or voluntary retirement. Due to successful buyout offers, the number of retirees is increasing. As a result of this factor alone, the cost of health insurance for existing retirees can be expected to grow.

⁵ See Table II-2, *infra*. These continuing losses from underwater products, including the Postal Service's inability to use its "pricing flexibility" to reduce, much less eliminate, them, was the Commission's principal finding relating to pricing in its last ACD. See FY 2011 ACD, p. 6.

C. Under PAEA, Net Worth Has Sunk to a Negative \$34.8 Billion in FY 2012, While Indebtedness Hit Its Statutory Limit of \$15 Billion.

To make PAEA-required contributions to the RHBF that could not be funded with net cash flow from operations, the Postal Service first exhausted its small reserves accumulated under the prior legislative scheme, the Postal Reorganization Act of 1970 (“PRA”),⁶ and then had to resort to extensive borrowing. By any measure, PAEA has been financially ruinous for the Postal Service:

- **Indebtedness** has increased from **\$2.1 billion** to the **\$15.0 billion** statutory debt limit.⁷
- An **\$11.1 billion default** due Treasury for the RHBF, and an additional default of \$5.5 billion in FY 2013.
- **Net worth has plummeted over \$40 billion**, from a **positive \$6.3 billion** to a **negative \$34.8 billion** at the end of FY 2012.⁸

It now should be apparent to all that PAEA has undermined Postal Service finances completely, despite the fact that the modern system for regulating rates for market dominant products was supposed to be designed: “[t]o assure adequate revenues, **including retained earnings**, to maintain **financial stability**.” 39 U.S.C. § 3622(b)(5) (emphasis added). A negative net worth of \$34.8 billion at the end of FY 2012 means the Postal Service has not just failed to have adequate retained earnings, and failed to maintain financial stability, but has

⁶ PRA, unlike PAEA, had a financial breakeven requirement which prevented the Postal Service from generating sustained excess cash flow or increased net worth.

⁷ Postal Service borrowing authority has been restricted, under both PRA and PAEA, to no more than \$3 billion per year, and to an aggregate amount of no more than \$15 billion. 39 U.S.C. § 2005(a). *See* USPS FY 2012 10-K, p. 91, Note 4, Debt Limits.

⁸ USPS FY 2012 10-K, p. 81.

failed these objectives rather spectacularly. As discussed in Section I.A, *supra*, in both FY 2011 and FY 2012 the Postal Service clearly came nowhere close to complying with this key PAEA objective, even though compliance is critically important to independent survival — which would end abruptly if **taxpayers** are called upon to provide the Postal Service with annual operating subsidies.⁹

D. The Postal Service Expects Yet Another Significant Operating Loss in FY 2013.

In the current year, FY 2013, the Postal Service expects operating expenses to decrease by \$0.8 billion. Because of the anticipated further decline in volume of profitable mail, however, an **operating loss of \$2.0 billion this fiscal year is projected.**¹⁰

The fiscal year (FY) 2013 **Integrated Financial Plan (IFP)** has a **projected Operating Loss of \$2.0 billion**, versus Operating Losses of \$2.4 billion in FY2012 and \$2.7 billion in FY2011. The reductions in Operating Losses are a result of our continuing efforts to increase revenue and reduce costs. [FY 2013 Integrated Financial Plan (“IFP”), p. 1 (emphasis added).]

The IFP’s projected operating loss of \$2.0 billion is premised on:

- a further decline in **First-Class Mail** volume of 3.2 billion pieces, or 6.1 percent, from FY 2012 levels, and
- a decline in **Standard Mail** of 2.5 billion pieces, or 3.1 percent, from FY 2012 levels. [FY 2013 IFP, p. 3.]

⁹ The Commission’s Annual Report to the President and Congress, FY 2012 (Jan. 2013), indicates that under PAEA the Postal Service has reported a significant cumulative loss through FY 2012, principally caused by the \$20.9 billion spent to pre-fund retiree health benefits. The Report acknowledges, appropriately, that the Postal Service is at risk of a cash shortfall, and “continued losses in revenue may seriously hamper the Postal Service’s ability to pay for basic operations in the very near future.” *Id.*, pp. 27-29.

¹⁰ See FY 2013 Integrated Financial Plan (“IFP”), p. 4. The \$2.0 billion operating loss includes payments for current retiree health benefits.

To evaluate the reasonableness of the above forecast, last year's FY 2012 IFP **projected a \$3.0 billion operating loss** (FY 2012 IFP, p. 1). That undershot the mark considerably, as the Postal Service suffered **an actual operating loss of \$4.6 billion** (*see* Table I-1, *supra*). The Postal Service projects the volume of First-Class Mail will continue to decline, falling to just 40 billion pieces by 2020. *See* GAO Report No. 13-112, p. 10. Based on these trends, it would be premature to be encouraged by the Postal Service's projected operating loss of "only" \$2.0 billion in FY 2013 — versus an actual \$4.6 billion loss in FY 2012 — as reflecting a turnaround.

Moreover, the Postal Service questions its own ability to operate independently in this year's IFP, which states that:

we estimate that we will **end FY2013 with a cash balance of only \$0.8 billion**. Additionally, we will have a number of days during the year when our cash or liquidity balance is near \$1.0 billion, which represents approximately **four days** of average daily expenses. If either projected revenues or expense reductions fail to achieve expectations, the risk of a cash shortfall becomes significant.... Just a one percent error in our cash forecasting will result in a \$1.3 billion adjustment to cash. [FY 2013 IFP, p. 1 (emphasis added).]

Although the IFP acknowledges that the Postal Service could be unable to pay all of its current operating expenses, the most recent 10-K assumes the availability of a taxpayer bailout:

The Postal Service is widely recognized as the provider of an essential government service and ... [t]herefore, it is **unlikely** that, in the event of a cash shortfall, the **Federal Government would cause or allow it to significantly curtail or cease operations**. [USPS FY 2012 10-K, p. 86 (emphasis added).]

Of course, even if the government intervenes to keep the Postal Service operating, any such intervention likely will come with strings attached.¹¹

E. The Cost of Maintaining the Universal Service Obligation Far Outweighs Any Value Received by the Postal Service from the Monopoly.

The Universal Service Obligation (“USO”) includes maintaining the extensive infrastructure of uneconomic post offices, six-day-per-week residential mail delivery, discounts for nonprofit mail, etc. The Commission recently concluded that cost of the USO has continued to increase. In **FY 2008** the estimated cost was **\$4.8 billion**, but by **FY 2011**, the cost of the USO had increased by 12.5 percent, to **\$5.4 billion**. See Postal Regulatory Commission Annual Report to the President and Congress, FY 2012, pp. 37-40 (Table IV-1).¹² Annual cost of the USO has risen to the point where it now about equals PAEA’s required annual payments to the RHBFB. Although the USO is largely imposed by Congress, at no time has that body indicated any willingness to appropriate taxpayer money to help support the USO costs it imposes on the Postal Service.

One premise underlying the USO was that the Postal Service would be allowed to raise prices as necessary to support it, regardless of how costly those activities might be, or might become. PAEA’s price cap deliberately undermined this source of funds to support the USO.

¹¹ Results for the first two months of FY 2013 (October-November 2012) offer a glimmer of hope. Compared with the same two months in FY 2012, the volume of First-Class Mail was down only 3.6 percent — somewhat less than the 6.1 percent annual decline projected by the FY 2013 IFP. Standard Mail volume was up 6.3 percent — considerably more than the 3.1 percent decline projected by the IFP. USPS Preliminary Financial Information (Unaudited), November 2012, p. 2 (filed Dec. 26, 2012), http://www.prc.gov/Docs/79/79064/NOV-11_PRC_-_Final_2.pdf.

¹² http://www.prc.gov/Docs/86/86069/PRC_2012_Annual_Report_w-links.pdf.

Additionally, the Postal Service business model long assumed that the **monopoly on letter mail** would help support USO costs. However, this monopoly has not proven an effective barrier to erosion of the volume of highly profitable First-Class Mail. While cost of the USO has been growing, for the same period a Commission study estimates that the **value of the postal monopoly declined by over 40 percent** — from \$3.0 billion to \$1.7 billion. *Id.*, p. 40, Table IV-3. Further, that estimate of the value of the monopoly is based on possible diversion of mail to competitors who would deliver hard copy if the postal monopoly ceased to exist. The hypothetical threat of profit-seeking entrepreneurs wanting to enter the hard-copy delivery market, with total mail volume in sharp decline, now seems optimistic. At the same time, diversion of First-Class Mail to the Internet, which clearly is not a hypothetical threat, received relatively scant weight in the Commission's study.

Quite obviously, the monopoly has not been able to stem erosion in the volume of First-Class Mail to the Internet. Moreover, the filings of the Postal Service and its partner, Valassis, in Docket No. MC2012-14/R2012-8 (the Valassis NSA), indicates that the monopoly no longer prevents delivery of hard copy by private sector competitors from undermining the volume of highly-profitable High Density/Saturation mail. The economic “rent,” or surplus, previously enabled by the monopoly has been severely eroded, probably forever. It is questionable whether the monopoly now has any meaningful residual value capable of providing meaningful support for the USO. At the very least, the Commission's study is in serious need of revision to take account of current and ongoing developments in electronic communication.

The time has come for the Commission to advise Congress that, if it really wants to continue imposing these high USO costs, the costs can no longer be supported by the monopoly, and Congress should fund them — possibly by crediting the cost of the USO toward pre-funding of the RHPF.¹³ It should be said that neither Valpak nor the industry wants taxpayer support for postal operations. Rather, Valpak seeks to free the Postal Service of congressionally imposed, artificial financial burdens.

F. The Price Cap and Defective Pricing Policy Have Combined to Undermine Postal Service Finances.

In addition to erosion of the postal monopoly, Postal Service pricing now is constrained by a price cap which limits increases in prices, revenues and contribution. The Commission's FY 2012 Annual Report to the President and Congress cogently noted that:

To cover **only operating costs**, without the RHBF payment, a **seven percent increase in revenue** would have been necessary to break even. The actual CPI-U capped average rate increase was [only] **2.133 percent**. [*Id.*, p. 28 (emphasis added).]

The Commission has put its finger on an extremely important issue. Under the price cap, the Postal Service clearly cannot raise prices by the additional 5 percent necessary to close the gap between operating revenue and costs, except via an exigent price increase. Although the Postal Service has not used its intra-class pricing flexibility wisely, whether the Postal Service could

¹³ PAEA envisions that the Commission will monitor and report to the President and Congress on the financial condition of the Postal Service, specifically including “the extent to which regulations are achieving the objectives under sections 3622 and 3633....” *See, e.g.*, 39 U.S.C. § 3651(a) (“Annual Reports by the Commission”). *See also* PAEA § 701 (uncodified, set out as notes under 39 U.S.C. § 501) (five-year “assessments of ratemaking, classification, and other provisions”). The PRC sent its first five-year report to Congress on September 22, 2011 (“Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006”), http://www.prc.gov/Docs/75/75994/701_Report-092211.pdf.

ever achieve sustained profitability under the price cap is unproven. It certainly does not help that those responsible for pricing seem to have an affinity for endlessly nurturing money-losing products, while believing that prices of profitable products can be driven ever higher with no adverse long-term consequences.¹⁴

The Postal Service's FY 2012 ACR limits itself largely to presentation of required information, and does not address possible corrective pricing actions that are vitally needed for survival as a financially self-supporting entity.¹⁵ The ACR demonstrates rather conclusively that rote compliance with filing requirements under PAEA almost certainly will not be sufficient to return Postal Service operations to financial self-sufficiency. Postal pricing urgently needs serious reform. PAEA gave the Postal Service pricing flexibility with wide latitude but set few standards for desired financial goals or the minimum acceptable level of contribution from any product or class of mail. Without such guidance, the Postal Service

¹⁴ True to form, the Postal Service's recent *Plan to Profitability* (Feb. 16, 2012) proposes that Congress hike the price of single-piece First-Class Mail, one of its most profitable products, earning \$10.5 billion in FY2012, to \$0.50, while leaving protected its underwater and marginally profitable products. http://about.usps.com/news/national-releases/2012/pr12_0217profitability.pdf.

With the advent of alternatives, especially electronic alternatives, the mailing public is increasingly taking advantage of opportunities to save on postage. Although demand still may be inelastic in the short term, the steep decline in the volume of First-Class Mail indicates that over longer periods it may be increasingly elastic.

¹⁵ This year's ACR submission gives more attention to rationalizing inadequate pricing on underwater products than it does addressing how it can survive in times of fiscal crisis.

seems adrift.¹⁶ This year's ACD should make Congress aware that, in the absence of more specific direction, the Postal Service may be incapable of generating net operating revenues.¹⁷

G. The Postal Service Suffers from an Adverse Product Mix, and the Problem Worsens Each Year with Continuing Decline in the Volume of First-Class Mail.

The Commission's FY 2011 ACD put its collective finger on a critical aspect of the Postal Service's core problem when it observed that:

Many market dominant products that are shrinking realize profits. Conversely, many market dominant **products that are growing or stabilized are contributing minimally.** [*Id.*, p. 34 (emphasis added).]

Although First-Class Mail volume has declined rather precipitously, in FY 2011 it still provided almost two-thirds of the Postal Service's operating profits.¹⁸ FY 2011 ACD, Figure

¹⁶ In economic parlance, the residual owners of the Postal Service are taxpayers, represented by Congress, which delegated initial responsibility for protecting ownership interests to the Board of Governors. Unfortunately, the Governors appear to have illegally re-delegated their authority over matters of pricing and profitability to management. *See* Valpak Initial Comments, Docket No. MC2012-14, (May 23, 2012), pp. 3-6.

¹⁷ The price cap is imposed on each class of mail. Changing the statute to have the rate cap apply to all market dominant products considered together might have some merit. However, it will not be a cure for underwater products so long as the Postal Service insists on using its pricing flexibility to continue giving average or even below-average price adjustments to underwater products. Although a single cap on all four classes of mail would give the Postal Service more freedom to act like a business, any such change at this time would be ill-advised because the Postal Service has demonstrated that it cannot be trusted to conduct its affairs in the manner of a business — where ownership interests normally dominate policy and pricing decisions.

¹⁸ Decline in mail volume, especially the volume of First-Class Mail, now is believed by most observers to be both permanent and continuing. *See, e.g.*, 2011 Form 10-K Report, p. 41, Revenue Outlook. Under PAEA, First-Class Mail volume has declined 27 percent, from **95.9 billion** pieces in FY 2007 to **91.7 billion** pieces in FY 2008, to **83.8 billion** pieces in FY 2009, to **78.2 billion** pieces in FY 2010, to **73.7 billion** pieces in FY 2011, and

IV-2, p. 34. With such heavy reliance on First-Class Mail to cover fixed costs, the current Postal Service business model could be described as not far removed from being a “one-trick pony.” This adverse product mix is an integral part of the Postal Service’s core problem. The distribution of products by contribution level is almost bi-modal:

- Those comparatively few products with **very high coverage** have volume that either is shrinking or vulnerable to diversion.
- A plethora of products are either **(i) underwater or (ii) make minimal contribution** to fixed network costs.

The Postal Service’s underwater products discussed in Sections II-IV, *infra*, are the worst — but not the only — part of the problem. A large volume of marginally profitable mail largely gets a “free ride” with respect to making a meaningful contribution to fixed network costs. The Postal Service needs to broaden and diversify the base of products that contribute meaningfully to fixed costs. Long before First-Class Mail volume declines to 40 billion pieces, the Postal Service will need to adjust prices in ways designed to **increase the contribution from every low-profit postal product**, to help assure that revenues from each product:

- Not only **cover attributable costs**,¹⁹ but also

to **69.6 billion** pieces in FY 2012. The Postal Service expects that volume will decline to approximately **40 billion** pieces by FY 2020.

¹⁹ The GAO study on funding the RHBF notes that prior to PAEA the value of retiree benefits accrued for current employees was not actuarially based. *Id.*, p. 40. Presumably, the cost of those benefits was not reflected in attributable costs or in postal prices. To the extent this observation of GAO is correct, on a full accrual basis some products now deemed minimally profitable actually might be underwater.

- make a **reasonable, meaningful contribution** to institutional costs (*see* 39 U.S.C. §§ 3622(c)(2) and 101(d)).

Even having each product cover 100 percent of its attributable costs does not pay the Postmaster General's salary. **Somebody must pay the Postal Service's institutional costs.**

Upward price adjustments within the cap need to focus largely on products that either are underwater, or are only marginally profitable, **until coverage on those products increases to a level of at least 130 to 135 percent.** If the Postal Service intends to start operating like a business, it should cease adjusting prices in a manner that would suggest it prefers to operate like a philanthropy. A large aggregate contribution to sustain network fixed costs is essential, because the extent to which fixed costs can be reduced is limited, *e.g.*, by the nature of the delivery network.²⁰ Continued decline in First-Class Mail means that, in the absence of Congressional (taxpayer) infusions, sooner or later the Postal Service will have to change its long-standing pricing policy so as to focus on obtaining a distinctly higher coverage from the portion of the mail stream that now contributes only minimally to fixed network costs. The sooner this happens, the better. If the Postal Service waits until First-Class Mail hits 40 billion pieces before increasing coverage on underwater and low coverage products, it likely will require taxpayer support.

Admittedly, it is unknown what will happen if the Postal Service begins to use its pricing flexibility to achieve a markedly higher contribution from marginal products, because

²⁰ The delivery network, where the Universal Service Obligation requires that carriers ply their fixed routes daily regardless of the mail volume that needs to be delivered, causes the Postal Service to have significant fixed costs, toward which many products make little or no contribution.

prices will need to be increased far above the range where current elasticity estimates apply. A substantial portion of those marginally profitable products may not be willing to pay a price that is significantly higher (*e.g.*, 25 to 40 percent more). The volume of those products then could decline to the point where the Postal Service will continue having considerable excess capacity and redundant costs that will require still further downsizing and restructuring, as the Postal Service struggles to achieve financial self-sufficiency. Succinctly put, the Postal Service's existence as a financially self-sufficient organization may be teetering on the verge of a downward spiral. There is little time for delay to determine how much volume is profitable, both covering its costs and making a reasonable contribution to institutional costs, and to right-size the company accordingly.

H. Whether the Postal Service Ever Can Achieve Sustained Profitability under PAEA Is Far from Assured.

The following four features of PAEA have been demonstrated to be **fundamentally incompatible**:

1. the objective to assure revenues adequate for **financial stability and retained earnings**;
2. the PAEA-imposed burden to **pre-fund** future retiree health benefits in the amount of \$56 billion within only 10 years;
3. the CPI **price cap**, along with Postal Service pricing flexibility, which generally takes precedence over all statutory objectives, including the one for financial stability cited here; and
4. The **lack of any authority to reduce operating expenses** or a mandate to give top priority to operating profits and prefunding of the RHBF.

Considered together, these four features were incompatible then, they are incompatible now, and they will continue to be incompatible in the future. PAEA itself virtually guaranteed that the Postal Service could **not comply** with the key objective of **financial stability** embodied in 39 U.S.C. section 3622(b)(5).²¹ The statutory price cap constraint alone, made it unlikely that any pricing system designed by the Commission could have prevented the current financial crisis. At best, it might have been delayed for one or two years. The absence of cost-cutting authority made operating losses highly likely. The PAEA burden was superimposed on the other problems. And the Postal Service's policy of nurturing underwater products made everything much worse.

Last year's ACD made no effort to whitewash the severity of the Postal Service's financial situation:

In FY 2011, the Postal Service's financial condition continued to deteriorate. At the end of FY 2012, it will not have sufficient cash to meet its Retiree Health Benefits Fund (RHBF) obligation. Even without this obligation, the Postal Service soon may be unable to meet payroll or pay its other bills. [FY 2011 ACD, p. 5.]

Indeed, the Postal Service's financial situation did deteriorate further in FY 2012, as last year's ACD anticipated. However, corrective actions which are vitally needed to comply with 39

²¹ The present liquidity crisis was clearly foreseeable, even if the precise timing was slightly less predictable. In 2006, the Board of Governors felt constrained as fiduciaries for the mailing public to take the politically-difficult step of strongly opposing enactment of PAEA. *See, e.g.*, U.S. Postal Service Board of Governors letter to Senator Susan M. Collins, Jan. 24, 2006 (“[W]e believe there are critical elements missing from this bill, as well as numerous burdensome provisions that would make it extremely difficult for the Postal Service to function in a modern, competitive environment.... [I]n keeping with our concerns that the Postal Service be able to provide the quality of service and reasonable rates ... we must oppose the passage of this bill.”) <http://www.apwu.org/postalreform/boglettertosencollins012406.pdf>.

U.S.C. section 3622(b)(5) and survive as a financially self-supporting entity presumably are not considered by the Postal Service to be compliance matters, and they therefore go unaddressed in the ACR.²² In FY 2013, the Postal Service teeters on the brink of running out of money.²³

The net cash to be used in operating the Postal Service during 2013 is estimated to be \$1.3 billion. With a beginning balance of \$2.1 billion, we expect to end the year with only \$0.8 billion of cash. This is **a dangerously low level of liquidity** as it is equivalent to less than four days of operating costs. This projection assumes that we are able to achieve our operating plan with significant cost reductions and **no unforeseen drops in revenue**. As of September 30, 2012, we had **reached the statutory \$15 billion debt limit**. [FY 2013 IFP, p. 6 (emphasis added).]

In the near term, at least, significant enhancement of **profitable** mail volume appears unlikely.²⁴ Neither Congress nor the Commission nor the Postal Service can force mailers to

²² The recital of compliance in the ACR submitted by the Postal Service this year could be likened to dutifully, competently, and very neatly arranging deck chairs on the RMS Titanic — prices and discounts both comply with PAEA. It scarcely hints at the Postal Service’s desperate financial condition. One might be forgiven for thinking that compliance (and the ACR) should address how to keep the ship afloat, not just complying with all the nitty-gritty provisions of PAEA while the ship gradually sinks below the surface.

²³ Short-term, any Postal Service overpayment to the Federal Employees Retirement System (“FERS”) could be refunded to alleviate the shortage of cash. The extent of any overpayment to FERS does not seem to be a settled amount, however. As this overpayment was never taxpayer money, a refund of such money should not be considered a “bailout.” Considering the rate at which the Postal Service is burning through cash, though, that cash would not last long. When it is gone, unless the Postal Service has returned to profitability, it would likely need some kind of bailout.

²⁴ In view of the Postal Service’s current financial condition, the last thing that it needs would be a surge in the volume of underwater products. That could be the proverbial “straw that breaks the camel’s back.” Fortunately, no such surge appears likely. Similarly, a surge in the volume of mail that makes only minimal contribution would not be very helpful,

send any mail — let alone more mail. The Postal Service attempts to increase profits by focusing on summer sales, new products, NSAs, etc., in the hope that it may help in a small way, but incremental profits from those efforts will not overcome multi-billion dollar deficits.

As noted by GAO:

USPS has several initiatives to generate new revenue; however, such efforts are unlikely to generate enough revenue in time to offset the projected decline in mail volume. [*Id.*, p. 9.]

Thus, returning operations to profitability primarily means:

1. major reductions in costs,²⁵ and
2. increasing contribution from existing products within the limit allowed by the price cap.

1. Cost reductions. Existing labor contracts, which guarantee permanent employees full-time work and lifetime tenure, severely limit the Postal Service's flexibility with respect to control and reduction of labor costs, which continue to hover near 80 percent of total costs — despite investments in automation. Accepting the continuing decline in the volume of First-Class Mail, management has recommitted to reduce excess capacity and fixed overhead costs. *See* Section VI, *infra*. Regardless of whether Congress agrees to these or other initiatives, significant time will be required to plan, seek necessary approvals, and implement major cost reductions, and it is questionable whether costs will decline fast enough and far enough ever to enable a return to profitability. For example, the recent GAO report explained that:

given the Postal Service's need for a dramatic increase in contribution.

²⁵ Docket No. ACR2009, Valpak Initial Comments, pp. 22-28 (Feb. 1, 2010) and Docket No. ACR2010, Valpak Initial Comments, pp. 17-22 (Feb. 2, 2011).

PRC estimated a **lower** annual net savings—about **\$1.7 billion** after a 3-year phase-in period—as it noted that higher revenue losses were possible. In February 2012, USPS updated its projected net savings from 5-day delivery to **\$2.7 billion after a 3-year implementation period**. [GAO RHBF Report, p. 10 (emphasis added).]

2. Increase contribution from existing products. Price adjustments designed to (i) reduce losses from underwater products, and (ii) increase coverage on marginally profitable products, would help. However, the Postal Service perennially misuses its pricing flexibility to increase prices and erode competitiveness of its more successful products, so that it can continue nurturing products that lose money or make only a minimal contribution. As a business proposition, such pricing makes absolutely no sense.

The Commission has previously determined that:

[T]he PAEA’s **price cap** mechanism in section 3622(d)(1)(A) **takes precedence** over the statutory pricing objectives and factors in sections 3622(b) and (c), even if some of these can be considered quantitative. [FY 2010 ACD, p. 18 (emphasis added).]

Unfortunately, that determination relegates the objective in 39 U.S.C. section 3622(b)(5) to a secondary role, at best. Moreover, in the most recent price adjustment, Docket No. R2013-1, the Commission again deferred to the Postal Service’s claimed pricing flexibility, to the point where it preempted Commission responsibility with respect to 39 U.S.C. section 3622(b)(5).²⁶

²⁶ The Commission’s continuing tolerance of extensive losses on underwater products imposes a future financial burden that ultimately will have to be paid, one way or another, either (i) by other mailers, which would be grossly unfair, or (ii) by taxpayers (who can be expected to resist), or (iii) through major cuts in service (which may affect some stakeholders far more than others), or (iv) through some combination thereof. No free lunch is to be had from tolerating such continuing losses. Already, the Postal Service has proposed reductions in the level of service to First-Class Mail, as well as reduced daily hours of service

Until Congress explicitly asserts taxpayers ownership interest and directs the Postal Service to give priority to maximizing contribution, Postal Service pricing policy seems dominated by other priorities. The previously-discussed gap between the CPI-U capped average rate increase (2.133 percent) and the 7 percent increase in revenue necessary to achieve breakeven is more likely to widen than to narrow.

The USPS *Plan for Profitability* (Feb. 16, 2012) acknowledges that the Postal Service's current efforts to restructure will not by themselves be sufficient to return operations to profitability and undo some of the financial damage inflicted by PAEA. According to that plan, elimination of Saturday delivery and establishment of the Postal Service's own health care plan are among the legislative changes proposed, which will require Congressional authorization (or at least acquiescence). Even with such legislation, however, the Postal Service may not be able to reduce costs or increase contribution by an amount sufficient to restore sustained profitability.

I. PAEA-Mandated Funding for Retiree Health Care Benefits Needs Reform, but Will Not Cure the Postal Service's Core Problem.

The requirement that the Postal Service pay for retiree health benefits is not new. All federal government retirees, including postal workers, are entitled to health care benefits.²⁷

at over 13,000 post offices. The Postal Service suggests an exigent rate case or legislation to increase the price for a single-piece letter to \$0.50. [*Plan for Profitability* (Feb. 16, 2012), p. 13.]

²⁷ If the Postal Service were a private corporation, given its financial distress, it might well discontinue providing health care benefits to retirees. This is not an option, however, so long as the Postal Service is a government-owned enterprise and such benefits are provided to other government workers.

Ever since the Postal Service was created from the former Post Office Department in 1971, it has funded health insurance premiums for current retirees each year on a pay-as-you-go basis as part of the regular operating budget.²⁸

What is comparatively new is the RHBF, created under PAEA for the purpose of **pre-funding** health benefits for retirees. Pub. L. 109-435 established a 10-year schedule of payments averaging \$5.6 billion per year that the Postal Service was required to pay into the RHBF. These pre-funding payments to the RHBF are in addition to cash outlays for pay-as-you-go insurance premiums covering current retirees.²⁹ See Table I-1, rows 4 and 6. These pre-funding requirements impose a heavy burden on the Postal Service, and sooner or later, Congress needs to address them. But RHBF is not, and should not be confused with, the Postal Service's core problem: lack of operating profits coupled with failure to act in a more business-like and competitive manner in matters such as pricing.

Neither the total amount (\$56 billion) specified in PAEA, nor the annual amounts (\$5.6 billion), nor the period for pre-funding (10 years) were based on any actuarial considerations. Instead, the PAEA funding requirement seems to have been a convenient way to create the illusion of reducing the long-term deficit in the unified budget without any increase in taxes or

²⁸ In the early years following PRA's enactment, the Postal Service (meaning rate payers) may have paid the full "legacy costs" of health care benefits for retirees who accrued those benefits during years when they worked for the old Post Office Department when it was a line agency of government.

²⁹ During FY 2012, the balance in the RHBF increased \$1.6 billion, from \$44.1 billion to \$45.7 billion. See USPS FY 2012 10-K, p. 100. As a result of this substantial reserve, the Postal Service may be positioned as well as any other public or private organization that has an obligation to pay for retiree health benefits.

reductions in spending. The motivation appears to have been driven to achieve a particular Congressional Budget Office (“CBO”) “scoring” of the bill. When PAEA was enacted, Congress implicitly (and heroically) assumed that the Postal Service could generate an additional \$5+ billion per year in profits and free cash flow without (i) increasing rates above the price cap and (ii) without enabling any major reductions in cost. Predictably, this has not worked.

As the Postal Service is supposed to be self-supporting, it was excluded from the government’s unified budget — *i.e.*, the Postal Service is “off-budget,” which has certain benefits.³⁰ At the same time, this off-budget status presents problems, as the Postal Service’s obligations to Treasury are considered “income” to Treasury (like taxes) and thereby help reduce the deficit.³¹ Any increases in the Postal Service’s general tariff schedule to help pay for such obligations could be likened to a “stamp tax,” collected by the Postal Service and paid to Treasury.³²

³⁰ Even when the federal government shuts down temporarily (as it has on occasion), the Postal Service is unaffected and continues accepting and delivering mail.

³¹ See OIG Report *Federal Budget Treatment of the Postal Service*, ESS-WP-09-001 (Aug. 27, 2009). If the Postal Service were included in the unified budget, no such reduction would have been possible through such legislation (which was one purpose of having a unified budget). Had Congress observed the spirit of the unified budget, no such provision would have been enacted.

³² Under normal circumstances, price increases above CPI are now precluded by the price cap. However, the Postal Service’s *Plan to Profitability* (Feb. 16, 2012) mentions the possibility of a “[p]ending exigent [rate] case” at p. 13. Should the Commission approve an exigent rate increase in order to help the Postal Service pay Treasury, the analogy to a stamp tax could be applicable. Under PRA, *i.e.*, prior to enactment of the rate cap, at least one OBRA included a legislated mandate that had to be included in a rate increase.

At the time PAEA was enacted, the entire \$56 billion was “scored” (by the scorekeeper, CBO) as a reduction in the long-term (10-year) projected deficit.³³ That scoring decision by the CBO obviously did not consider the fact that neither the Postal Service’s balance sheet, nor its cash flow under the new price cap, ever could enable all such payments to be made. Once the entire \$56 billion was scored as reducing the long-term deficit, however, one effect of any subsequent permanent reduction in that statutory obligation would be to reverse the prior reduction and increase the long-term deficit. Moreover, re-scheduling any of the required payments over a period longer than 10 years also might have the effect of increasing the long-term deficit.³⁴ PAEA, the Postal Service’s off-budget status, and the CBO scoring decision have had the effect of painting both Congress and the Postal Service into a corner.

Since the RHBF problem was created by Congress, only Congress can fix it. Regardless of how often and by what means Congress elects to deal with the RHBF situation created by PAEA, Valpak would suggest that it is past time for explicit recognition by Congress that funding of the RHBF is not going to work as envisioned in 2006 when PAEA was enacted. Broadly speaking, all possible outcomes appear to fall under one of three broad approaches, discussed below.

³³ Projections for the unified budget extend for a 10-year horizon, which likely explains why the Postal Service was required to fund the RHBF over 10 years.

³⁴ This helps explain why temporary abatements in FY 2009 and FY 2011 allowed by Congress were re-scheduled to be paid within the 10-year period — not stretched out beyond that time, and not canceled.

1. Do Nothing.

Realistically, the Postal Service currently has no means by which it could pay any part of the \$11.1 billion default to Treasury in FY 2012, or the \$5.6 billion obligation to the RHBF due this fiscal year — much less next year, or the year after. To the extent that any light exists at the end of the tunnel, this year's USPS 10-K notes that:

The statutory requirement establishing the payment schedule (P.L. 109-435) contains no provisions addressing a payment default. As of November 15, 2012, no penalties or adverse consequences have resulted. [*Id.*, p. 84.]

That means, absent any Congressional action on the RHBF issue, that the Postal Service can continue to function. Not taking any action and “kicking the can down the road” is thus one option available to Congress. Absent any Congressional action, the only “solution” this year may be to for the Postal Service to continue (i) paying retiree health care premiums as part of current operating expenses, and (ii) defaulting on remaining RHBF payments as they become due. Should Congress not take any action this year, then after the next default occurs at the end of FY 2013, the Postal Service's balance sheet would reflect (i) an increase in the amount owed to Treasury for the RHBF, and (ii) an increased deficit in its net worth account.

Meanwhile, interest would continue to accumulate in the RHBF. With the Postal Service now having little liquidity, and faced with the specter of yet another default, it will be under pressure throughout the year to accelerate retirement of eligible employees and otherwise cut

expenses “to the bone.”³⁵ Congressional inaction this year, of course, resolves nothing as regards continuing Postal Service deficits or funding of the RHBF.

2. Modify the RHBF Funding Requirement.

The recent GAO study, after examining several alternative approaches for the Postal Service to fund the RHBF up to the required limit, stated that:

None of the funding approaches will be viable unless USPS has the ability to make the required payments. Without congressional or further USPS actions to cut postal costs, USPS will not have the finances needed to make annual payments in the short term and reduce its retiree health unfunded liability over the long term. ... While USPS may have limited control of its revenue stream because of advances in technological communication, it is **important that USPS reduce its expenses to avoid even greater financial losses, repay its outstanding debt, and increase capital for investment. Consequently, as we have repeatedly stated, Congress and USPS need to reach agreement on a comprehensive package of actions to improve USPS’s financial viability. [Status, Financial Outlook, and Alternative Approaches to Fund Retiree Health Benefits, GAO-13-112, p. 49 (emphasis added).]**

Ironically, the above “disclaimer” by GAO means that all of its funding schemes are irrelevant until the Postal Service can begin to produce significant net profits each year. As discussed in Sections I-F to H, *supra*, returning the Postal Service to profitability will be neither easy nor quick. Simply making up for accumulated deficits already on the balance sheet will require many years of positive profits. In this year’s ACD, the Commission should help Congress understand that its focus needs to prioritize the most desirable ways to fix the Postal Service’s

³⁵ On January 15, 2013, the Postal Service issued a press release stating “Board of Governors Directs Postal Service Management to Accelerate Steps to Restructure Postal Operations and Reduce Costs.” Under the existing circumstances created by PAEA, Congressional inaction is one way to prod the Postal Service to step up to the plate and finally get really serious about making some hard cost cutting decisions.

business model in a way that not only will reduce expenses by an amount sufficient to get the Postal Service back above financial breakeven, and also keep it sustainable at that level for a prolonged period.

3. Allow the Postal Service to Sponsor its Own Health Care Plan

The Postal Service understands that it has been “boxed in” by having the RHBFF funding requirement scored as deficit reduction. In an effort to get out of the box, the Postal Service recently has proposed a plan under which all of its current employees and retirees would be removed from the Federal Employees Health Benefit Program (“FEHBP”) and instead be covered by a new, separate plan, to be set up and administered by the Postal Service. The Postal Service claims that its proposal would eliminate entirely the funding deficit created by the PAEA. That proposal is currently the subject of a study by the GAO, obviously is not now in effect, and would require Congressional approval in order to take effect. It also may be somewhat controversial. Accordingly, it is not ripe for comment in the Annual Compliance Determination.

Even if this approach can make the RHBFF issue disappear completely, as the Postal Service claims, it still will (i) have no borrowing authority (because its debt is at the \$15 billion statutory limit), (ii) have no surplus on its balance sheet, and (iii) be operating at a deficit. Funding of retiree health benefits requires that the Postal Service be able to generate **operating profits** sufficient at least to reduce its current default and other debt. That is why a return to **operating profitability** is so important. And that cannot happen until Congress enables Postal Service restructuring with respect to implementation of major cost reductions.

II. THE POSTAL SERVICE'S FINANCIAL WOES ARE IN LARGE PART DUE TO SELF-INFLICTED LOSSES FROM UNDERWATER PRODUCTS.

A. In FY 2012, the Postal Service Lost Almost \$1.5 Billion on Eight Products.

The Postal Service's ACR once again demonstrates the continued failure of a large number of market dominant products to achieve 100 percent cost coverage. Postal Service losses on eight market dominant mailing products totaled **\$1.461 billion** in FY 2012. This is a slightly less terrible outcome than the \$1.615 billion loss sustained in FY 2011. Losses during FY 2011 and FY 2012 for each of eight products are set out in Table II-1, *infra*. (The table contains nine products because Bound Printed Matter Parcels was underwater during FY 2011, but made a profit in FY 2012; First-Class Parcels is now underwater in FY 2012, but was not in FY 2011.)

Of the eight products losing money in FY 2012, the largest losses continue to be from Standard Flats and Periodicals Outside County. Losses from these two products alone (\$1.181 billion) make up 81 percent of the \$1.461 billion loss from all eight underwater products.

Two entire classes remain underwater: Periodicals (72.1 percent cost coverage) and Package Services (97.7 percent cost coverage).

Put into context, the loss from these eight products constituted almost **one-third** (31.5 percent) of the **Postal Service's FY 2012 operating loss** of \$4.641 billion. *See* Table I-1, *supra*. The Postal Service's dire financial circumstances mandate that the Commission take this problem seriously in the context of this Annual Compliance Review.

Table II-1
Loss-Generating Market Dominant Products, FY 2011-2012
(Exclusive of Special Services)

Product	FY 2011 Deficit (million)	FY 2011 Coverage	FY 2012 Deficit (million)	FY 2012 Coverage
First-Class Parcels	—	—	\$10	98.4%
Inbound Int. Single-Piece First-Class Mail	\$36	79.0%	\$66	65.8%
Standard Mail Flats	\$652	79.3%	\$532	80.7%
Standard Mail NFM's and Parcels	\$117	84.8%	\$53	84.3%
Periodicals Within County	\$20	77.5%	\$29	69.7%
Periodicals Outside County	\$597	74.5%	\$649	71.8%
Single-Piece Parcel Post	\$89	89.2%	\$66	92.1%
Bound Printed Matter Parcels	\$5	98.4%	—	—
Media and Library Mail	\$99	77.0%	\$56	85.1%
Total	\$1,615		\$1,461	

Sources: FY 2011 ACR, Tables 1-4; FY 2012 ACR, Tables 1-2, 4-5.

B. PAEA Requires the Commission to Evaluate Compliance of Products, Individually and Collectively.

As part of its Annual Compliance Review, 39 U.S.C. section 3653(b) requires the Commission to:

make a written determination as to — (1) whether any rates or fees in effect during such year (for products **individually or collectively**) were **not in compliance** with applicable provisions of this chapter (or regulations promulgated thereunder).... [39 U.S.C. § 3653(b) (emphasis added).]

Analyzed individually, the shortfall in Standard Flats is discussed in Section III, and the need for a strong remedial order is discussed in Section VI, *infra*. The shortfall in Periodicals and the need for a finding of noncompliance is discussed in Section VII, *infra*.

In the past, the Commission’s Annual Compliance Determination evaluated compliance for products individually, but not collectively. Of course, “collectively” could mean (i) all market dominant products, (ii) all products within a class, or (iii) all products that perennially lose money and together are a financial threat to the Postal Service’s survival as a financially independent entity; these comments focus on the third meaning. Viewed “collectively,” the eight underwater market dominant products violate: 39 U.S.C. section 3622(b)(5) (the objective of ensuring adequate revenues); 39 U.S.C. section 3622(c)(2) (the factor that each type of mail service bear its attributable costs and **make a contribution to institutional costs**); 39 U.S.C. section 101(d) (the mandate that the costs of all postal operations be apportioned to all users of the mail on a fair and equitable basis); and 39 U.S.C. section 403(c) (the prohibition against discriminatory pricing).

This problem is not new. Table II-2 identifies nine market dominant mailing products (other than special services) that have lost \$7.5 billion over the past five fiscal years.³⁶

Valpak's comments on the FY 2011 ACR briefly described this type of collective analysis with respect to underwater products. *See* Docket No. ACR2011, Valpak Initial Comments, pp. 41-43. While the Commission did not address that issue as part of its FY 2011 ACD, in this docket the Commission should address the collective group of products that have caused a revenue drain on the Postal Service since FY 2008. These losses on **underwater products** constitute nearly **two thirds** (62.9 percent) of the **Postal Service's operating loss** of \$11.984 billion over those same five years.

While two of the products were profitable in some years, **seven products have continuously lost money in each of these five years, totaling an astonishing \$7.480 billion.**

³⁶ As a transition year, information for FY 2007 was incomplete and does not compare well with some data since then.

Table II-2
Loss-Generating Market Dominant Products, FY 2008-2011
(Exclusive of Special Services)

Product	FY 2008 Deficit (million)	FY 2009 Deficit (million)	FY 2010 Deficit (million)	FY 2011 Deficit (million)	FY 2012 Deficit (million)	Total (million)
First-Class Parcels	—	—	\$1	—	\$10	\$11
Inbound Int. Single-Piece First-Class Mail	\$53	\$105	\$53	\$36	\$66	\$313
Standard Mail Flats	\$228	\$622	\$582	\$652	\$532	\$2,616
Standard Mail NFM's and Parcels	\$167	\$208	\$178	\$117	\$53	\$723
Periodicals Within County	\$5	\$15	\$25	\$20	\$29	\$94
Periodicals Outside County	\$450	\$643	\$598	\$597	\$649	\$2,937
Single-Piece Parcel Post	\$66	\$62	\$134	\$89	\$66	\$417
Bound Printed Matter Parcels	—	\$9	\$28	\$5	—	\$42
Media and Library Mail	\$60	\$75	\$90	\$99	\$56	\$380
Total	\$1,029	\$1,739	\$1,689	\$1,615	\$1,461	\$7,533

Sources: FY 2008-2012 ACRs.

Thus far, the Commission has found only that Standard Flats prices violated PAEA. Indeed, the Commission's disparate treatment of various underwater products opened the Commission to criticism from the Postal Service (for being arbitrary and capricious) and resulted in some confusion for the U.S. Court of Appeals when reviewing the FY 2010 ACD. The Court stated: "the Commission's order implied that only 100% cost coverage, and nothing short of 100%, would bring Standard Flats into compliance with § 101(d). This appears quite inconsistent with the Commission's treatment of other market-dominant products, several of which have comparable, or even lower, cost coverage than Standard Flats." United States Postal Service v. Postal Regulatory Commission, 676 F.3d 1105, 1108 (D.C. Cir. 2012). The Court added that "the Commission's explanatory gap is palpable." *Id.*

The Commission's order on remand in Docket No. ACR2010-R (Order No. 1427) justified both its finding for Standard Mail Flats and its failure to find other underwater products out of compliance. Even so, the Commission stated that "Rates that do not cover a product's attributable costs ... are subject to more careful scrutiny by the Commission because, among other things, any shortfall shifts burdens onto other mailers.... **The totality of circumstances** presented is critical to Commission evaluations under section 3653." Order No. 1427, p. 4 (emphasis added).

In this case, the "totality of circumstances" includes:

- (i) the collective, enormous amount of losses these products have created — almost \$7.5 billion over five years;
- (ii) the continuous nature of those losses over a five-year period;
- (iii) the adverse impact on the Postal Service's ability to survive financially;

(iv) the fact that the Postal Service has taken no meaningful steps to make these products profitable; and

(v) the fact that the Postal Service has no plan to make these products profitable.

All financial decisions involve tradeoffs. When the Postal Service underprices a product, and cannot extract extra contribution from other mailers as a cross-subsidy, it must cut costs, sometimes in ways it would not want to do, such as degrading First Class Mail Service Standards. A statute appears to constrain such action. 39 U.S.C. section 101(a) requires that “[t]he costs of establishing and maintaining the Postal Service shall not be apportioned to impair the overall value of such service to the people.” As 62.9 percent of the Postal Service’s operational deficit over the past five year has come from underwater products, this is the dominant reason the Postal Service has been seeking ways to cut service, including eliminating Saturday delivery, reducing overnight service for First-Class Mail and Periodicals, and closing or reducing the hours for a large number of post offices, stations, and branches. Since the “costs of ... maintaining the Postal Service” have not been apportioned appropriately, the Postal Service has been on a path to “impair the overall value of such service to the people,” in violation of this prohibition.

C. Finding Requested.

The following sections will focus more on the two largest problem areas: Standard Flats and the Periodicals class. In addition to the separate findings that Valpak urges in those latter sections, **Valpak requests the Commission to make a finding of noncompliance with respect to the seven products collectively that have been underwater continuously since FY 2008.** These seven products do not comply with the factors and objectives of 39 U.S.C.

section 3622, or the requirement of 39 U.S.C. section 101(d) that postal rates “apportion the costs of all postal operations to all users of the mail on a fair and equitable basis,” as well as 39 U.S.C. section 403(c), which prohibits the Postal Service from making rates and fees which “make any undue or unreasonable discrimination among users of the mails, [or] grant any undue or unreasonable preference to any such user,” and 39 U.S.C. section 101(a), discussed *supra*. By charging prices for these seven products which do not cover their costs year after year, the Postal Service is giving unreasonable preference to mailers who use those seven products, and discriminating against all other mailers who are compelled to make up for those losses by paying higher prices. Indeed, underwater products have forced the prices of some products to have cost coverages of well over 200 percent (*e.g.*, High Density/Saturation Letters and High Density/Saturation Flats and Parcels). *See* Section VI, *infra*. This finding should be accompanied by an appropriate remedial order.

Should the Commission choose not to make such a finding, then the U.S. Court of Appeals for the District of Columbia Circuit recently determined that the Commission has the responsibility and the duty clearly to “explain why [such] discrimination is due or reasonable under § 403.” Gamefly v. Postal Regulatory Commission, No. 11-1179 (D.C. Cir., Jan. 11, 2013), slip op., p. 9.

III. THE POSTAL SERVICE HAS ACTED TO ENSURE THAT THE PROBLEM OF DEEPLY UNDERWATER STANDARD MAIL FLATS PERSISTS, DESPITE THE COMMISSION’S TWO FINDINGS OF NONCOMPLIANCE WITH PAEA.

Although Standard Flats represents only 4.4 percent of market dominant mail volume, it threatens to help bring down the Postal Service financially, accounts for 11.5 percent of the

Postal Service’s operating loss. The Postal Service’s FY 2012 ACR reports that the Standard Mail Flats product lost over half a billion dollars — **\$532.1 million** — in FY 2012. This brings the five-year total loss for only one product to an astounding **\$2.6 billion**, as shown in Table III-1.

The Postal Service reports that the cost coverage for the product inched up 1.4 percentage points in FY 2012, to a still abysmal 80.7 percent. Even though the losses on Standard Flats have improved, the FY 2012 loss was still well over twice the loss incurred in FY 2008, and this occurred with less than 60 percent of the volume in FY 2008.

In vain, the Postal Service tries to put a positive spin on this dangerously priced product:

Standard Mail Flats had a cost coverage of 80.7 percent in FY 2012, **an increase of 1.4 percentage points** over FY 2011 that reverses three consecutive years of declining cost coverage. This increase materialized notwithstanding a 12.4 percent decline in volume in FY 2012. As the Postal Service has stated repeatedly in the past, it agrees with the Commission that having products cover their costs is an appropriate long-term goal. **This improvement in cost coverage takes a step in that direction.** [FY 2012 ACR, p. 15 (emphasis added).]

At the pace of improving 1.4 percentage points annually, it will require about 14 more annual “steps” (*i.e.*, until **FY 2026**) in that direction before Standard Mail Flats reaches full cost coverage. Many more years will be required for the product to make any noticeable contribution towards institutional costs.

As shown in Table III-1, all the numbers were down for Standard Flats. As volume was down 12.0 percent, revenue was down 10.5 percent, and costs also were down 12.1 percent. Mercifully, the volume loss resulted in the operating loss decreasing by 18.4 percent.

Table III-1
Standard Mail Flats Revenue, Costs and Contribution
FY 2008 – 2012
(millions)

<u>Fiscal Year</u>	<u>Revenue</u>	<u>Attributable Cost</u>	<u>Contribution</u>	<u>Volume</u>
2008	\$3,663.7	\$3,891.0	-\$227.3	10,010.875
2009	2,866.0	3,488.3	-622.3	7,793.511
2010	2,579.4	3,161.3	-581.9	7,049.230
2011	2,491.1	3,142.9	-651.8	6,783.186
2012	<u>2,229.6</u>	<u>2,761.7</u>	<u>-532.1</u>	5,939.635
TOTAL	\$13,829.8	\$16,445.2	-\$2,615.4	

Source: CRA for each respective year.

The future does not look any brighter. As Table III-2 shows, unit costs continued to increase, from 44.8 cents in FY 2009 and 2010, to 46.3 cents in FY 2011, to 46.5 cents in FY 2012. Without decisive Commission action, more billions of dollars will be lost.

Table III-2
Standard Flats Unit Revenue, Cost and Contribution
FY 2009 – 2012

<u>Fiscal Year</u>	<u>Revenue</u>	<u>Cost</u>	<u>Contribution</u>
2009	\$0.368	\$0.448	-\$0.080
2010	\$0.366	\$0.448	-\$0.083
2011	\$0.367	\$0.463	-\$0.096
2012	\$0.375	\$0.465	-\$0.090

Source: CRA for each respective year.

Standard Flats in FY 2012 continues the same pattern demonstrated in FY 2010 and FY 2011 when the Commission made findings of noncompliance for the product. As detailed in

Section IV, *infra*, the Postal Service's rationale contained in its FY 2012 ACR utterly fails to justify (a) the continued noncompliance of the Standard Flats product and (b) the failure to make meaningful changes in prices in response to the remedial order in FY 2010 ACD. Thus, the Commission is left in virtually the same position it was in when it found noncompliance in FY 2010 and FY 2011.

A. The Postal Service Has Continuously Resisted the Commission's Remedial Orders in FY 2010 ACD.

In the FY 2010 ACD, the Commission found that Standard Flats violated 39 U.S.C. section 101(d), and directed the Postal Service to take certain remedial actions:

Pursuant to section 3653(c), the Commission directs the Postal Service to increase the cost coverage of the Standard Mail Flats product through a combination of above-average price adjustments, consistent with the price cap requirements, and cost reductions until such time that the revenues for this product exceed attributable costs.

* * *

Within 90 days of the issuance of the FY 2010 ACD, the Postal Service shall present a schedule of future **above-CPI price increases** for Standard Mail Flats....

* * *

In subsequent ACRs, the Postal Service shall **report** the following information:

- describe all operational changes designed to reduce flat costs in the previous fiscal year and estimate the financial effects of such changes;
- describe all costing methodology or measurement improvements made in the previous fiscal year and estimate the financial effects of such changes;
- a statement summarizing the historical and current fiscal year subsidy of the Flats product; and, the estimated timeline for phasing out this subsidy.

In subsequent Notices of Market Dominant Price Adjustments, the Postal Service shall **report** the following information:

- an explanation of how the proposed prices will move the Flats cost coverage toward 100 percent, and

- a statement estimating the effect that the proposed prices will have in reducing the subsidy of the Flats product. [FY 2010 ACD, pp. 106-07 (emphasis added).]

The Postal Service filed a Petition for Review of the Commission's finding and order, and during the pendency of the appeal, the Commission stayed a portion of its order — the requirement to provide a schedule of above-CPI prices. *See* Order No. 739. In the FY 2011 ACD, the Commission once again found Standard Flats to be out of compliance, but did not order additional remedial action, because the appeal was still pending. *See* FY 2011 ACD, p. 119. On April 17, 2012, the U.S. Court of Appeals for the D.C. Circuit upheld the Commission's finding and remedial order, only remanding to the Commission for "definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity." USPS v. PRC, *supra*. In Order No. 1427, the Commission affirmed its remedial order and provided the explanation required by the court. Following that, in Order No. 1472, the Commission confirmed the termination of its partial stay, and ordered the Postal Service to provide the information required by the FY 2010 ACD as well as to provide the schedule of above-CPI price increases with the FY 2012 ACR. Accordingly, the Postal Service has had four specific opportunities to provide the information required by the remedial order and two opportunities to provide above-CPI prices increases. The question must be asked: How well did the Postal Service do in complying with the remedial order since it was issued?

1. Docket No. R2012-3

In its Notice of Market Dominant Price Adjustment in Docket No. R2013-1 (Oct. 18, 2011), the Postal Service purported to comply with the FY 2010 ACD by giving Standard Flats an above-CPI price increase, but only barely: the increase for Flats was **0.076** percentage points above the price cap, *i.e.*, in that case, $\text{CPI} * 1.035$. The Commission allowed this minimalist compliance in part because of the pendency of the appeal of the FY 2010 ACD and in part because the “Postal Service technically complied with the Commission’s directive.” Order No. 987, p. 32.

Additionally, the Postal Service failed to file the information that the FY 2010 ACD specified be filed in subsequent notices of market dominant price adjustments. Valpak pointed this out in its comments (Valpak Comments, pp. 12-13), but the Commission largely ignored the failure, only stating that it was “concerned with the lack of explanation provided by the Postal Service as directed in the FY 2010 ACD.” Order No. 987, p. 32. The Commission also stated that it “expects the Postal Service to file an explanation of how price increases and cost reductions are being used to reduce the intra-class cross-subsidy and to improve the cost coverage for Standard Flats in the next Annual Compliance Report.” *Id.*, p. 4.

2. Docket No. ACR2011

The Postal Service deliberately disregarded the FY 2010 ACD remedial order by not filing the required information with its FY 2011 ACR. ChIR No. 1, question 9 (Jan. 19, 2012) requested the information that the Postal Service should have filed with both the FY 2011 ACR and the Docket No. R2012-3 Notice of Market Dominant Price Adjustment.

3. Docket No. R2013-1

In the next pricing adjustment, once again, the Postal Service deliberately disregarded the Commission's remedial order, requiring the Commission to request the information. *See* CIR No. 1, question 1. The Postal Service's Notice also deliberately disregarded the remedial order to provide above-cap price adjustments for Standard Flats, instead purporting to give an **at-cap** price adjustment. After some recalculations, the actual proposed increase for Standard Flats was deemed to be **below cap**, and the Commission rejected and remanded the prices. On remand, the Postal Service provided an increase to Standard Flats that was even more *de minimis* than the **0.047** percentage points above the cap (here, $\text{CPI} * 1.018$). Nevertheless, the Commission approved the prices on remand, stating, "Although Valpak and the Public Representative take issue with the amount of the price increase, the Commission concludes that these rates comply with the FY 2010 ACD directives." Order No. 1573, p. 5. The only sense in which they could have been said to comply was that they were technically, barely, above average.

4. Docket No. ACR2012

In this docket, the Postal Service has again deliberately disregarded the FY 2010 ACD remedial order. It has become routine that one of the Commission's first actions after the filing of an ACR is issuance of an information request asking the Postal Service to provide the information required by the FY 2010 ACD remedial order, and the Commission had to do so again in the instant docket. *See* ChIR No. 1, question 2 (Jan. 4, 2013). Further questions were asked at Valpak's request. ChIR No. 4, questions 1-4.

It is indisputable that the Postal Service has not taken seriously either the Commission's remedial pricing order or the reporting requirements in the FY 2010 ACD — and it has gotten away with it. The Postal Service's failure to comply with the FY 2010 ACD remedial order when it had four opportunities to do so demonstrates a pattern of deliberate noncompliance which cannot be ignored without materially weakening the Commission's statutory authority and causing Congress to doubt the pricing system is working. With this backdrop, the Commission should now take such actions as are necessary to ensure Postal Service compliance regarding future filings with the Commission.³⁷

B. The Postal Service Must Believe Its Pricing Flexibility Trumps Commission Authority to Remedy Illegal Pricing Requires Issuance of a Highly Specific Remedial Order.

The Postal Service's noncompliance is not accidental, but reflects deliberate Postal Service policy. The FY 2012 ACR reveals that the Postal Service continues to resist mightily the Commission's authority to find Postal Service pricing in violation of PAEA, and to order into effect remedial price changes under 39 U.S.C. section 3653(c). For example, it devotes fully 10 percent of its ACR narrative to justifying the continuation of underpricing Standard Flats, despite the remedial order. FY 2012 ACR, pp. 15-19.

³⁷ The Commission has only just begun to touch on statutory enforcement powers given it under PAEA. The Commission has the power to order fines in cases of deliberate noncompliance (39 U.S.C. § 3662(d)) and the ability to seek relief from the federal district courts to enjoin the Postal Service from violating orders (39 U.S.C. § 3664). *See* section III.B, *infra*.

In its FY 2010 ACD, the Commission ordered the Postal Service to “present a schedule of future above-CPI price increases for Standard Mail Flats.”³⁸ The Postal Service delayed compliance by filing a Petition for Review of the Commission’s decision and obtaining a stay from the Commission based on that appeal,³⁹ but that appeal was decided on April 17, 2012, and the Commission’s explanation required by the Court was issued August 9, 2012.⁴⁰ As the Commission’s explanation did not directly address the Postal Service’s duties after remand, on September 21, 2012, the Commission expressly terminated its stay, and directed that the required schedule (termed “specific remedial action”) be filed with the Commission in its FY 2012 ACR, along with a narrative addressing above-average pricing (termed “general remedial action”):

1. In its **FY 2012 Annual Compliance Report**, the Postal Service shall present a **schedule of future price adjustments** for Standard Mail Flats as set forth in the body of this Order.

2. In its next Notice of Market Dominant Price Adjustment and **Annual Compliance Report**, the Postal Service shall provide **information on the general remedial actions** as described on pages 106-107 of the 2010 Annual Compliance

³⁸ FY 2010 ACD, p. 106 (Mar. 29, 2011), http://www.prc.gov/Docs/72/72382/PRC_ACD_2010.pdf.

³⁹ The Commission granted the Postal Service’s motion for leave to postpone filing a schedule, with the stay to “remain in effect until 30 days following resolution of the 2010 ACD petition for review.” Order No. 739, p. 3 (May 27, 2011), http://www.prc.gov/Docs/73/73096/Order_No_739.pdf.

⁴⁰ Docket No. ACR2010-R, Order No. 1427 (Aug. 9, 2012), http://www.prc.gov/Docs/84/84871/Order_1427.pdf.

Determination. [Docket No. ACR2010-R, Order No. 1472, p. 3 (Sept. 21, 2012) (emphasis added)⁴¹.]

With no further excuses for noncompliance, and ample time to prepare a meaningful filing, the Postal Service presented a schedule for only three years (FY 2014-16),⁴² where “planned flats price increases” are identical for each year — stated to be “CPI * 1.05.” Therefore, if CPI was 2.0 percent, the increase in Standard Flats would be 2.1 percent. The Postal Service stated that it only provided a three-year schedule “because of the Commission’s responsibility, pursuant to 39 U.S.C. section 3622(d)(3), to review the system for regulating rates ... in 2016.” FY 2012 ACR, p. 18, n.18. Viewing this reason to be inadequate, if not a transparent ruse to avoid compliance with a Commission remedial order, Valpak moved the Commission to inquire of the Postal Service for a proper response,⁴³ which the Commission did.⁴⁴

⁴¹ <http://www.prc.gov/Docs/85/85171/Order%201472.pdf>.

⁴² See Valpak Motion for Issuance of Information Request (Jan. 15, 2013), question 3, <http://www.prc.gov/Docs/86/86217/Valpak%20Motion%20for%20ChIR.pdf> and ChIR No. 4, question 3 (Jan. 18, 2013), <http://www.prc.gov/Docs/86/86255/CHIRNo4.pdf>.

⁴³ Valpak Motion for Issuance of Information Request, Docket No. ACR2012 (Jan. 15, 2013), <http://www.prc.gov/Docs/86/86217/Valpak%20Motion%20for%20ChIR.pdf>.

⁴⁴ Docket No. ACR2012, ChIR No. 4, questions 1-4 (Jan. 18, 2012), <http://www.prc.gov/Docs/86/86255/CHIRNo4.pdf>.

The Postal Service’s initial responses to ChIR No. 4, questions 1, 2, and 4⁴⁵ are discussed *infra*. The Postal Service later responded to ChIR No. 4, question 3,⁴⁶ where, the Postal Service calculated that with Standard Flats price increases of 105 percent of CPI, and assuming constant costs — an assumption which has no basis in fact — unit losses would shrink very slowly between FY 2013 and FY 2016, from 7.7 to 7.1 to 6.4 to 5.7 cents.

Although the Commission asked the Postal Service to make projections “until the unit revenue of the Flats product exceeds its unit attributable cost” (*id.*), the Postal Service (again) refused, stating “[t]he Postal Service questions the efficacy of providing projections beyond 2016, as such estimates would be highly speculative...” and further,

providing estimates until unit revenues exceed unit costs runs counter to the **Commission’s interpretation of its powers to order remedial action** pursuant to 39 U.S.C § 101(d); namely, that **compliance** with this section “**does not require** ‘only 100% cost coverage, and nothing short of 100%’” [referencing Docket No. ACR2010-R, Order No. 1427 (Aug. 9, 2012), at 14]. [USPS Response to ChIR No. 4, question 3, p. 2 (emphasis added).]

The Postal Service relies on the Commission’s **general policy statement** in Order No. 1427 responsive to the Court’s inquiry about the different treatment of other underwater products, that 39 U.S.C. section 101(d) **in all cases where coverage drops below 100 percent** mandates a finding of noncompliance. That general policy statement cannot be read to undermine the Commission’s **specific remedial order for Standard Flats**, where based on a variety of

⁴⁵ Docket No. ACR2012, USPS Response to ChIR Nos. 1-2 and 4-24 (Jan. 25, 2013), <http://www.prc.gov/Docs/86/86319/Responses.ChIR4.pdf>.

⁴⁶ Docket No. ACR2012, USPS Response to ChIR No. 4, Question 3 (Jan. 28, 2013), <http://www.prc.gov/Docs/86/86326/Response.ChIR4.Q3.pdf>.

factors taken together — in addition to coverage below 100 percent — led the Commission to make its finding:

The Commission does not interpret **section 101(d)** to require “only 100% cost coverage, and nothing short of 100%,” to satisfy the fair and equitable cost apportionment standard, provided an adequate explanation for a failure to improve cost coverages is offered. Cf. 676 F.3d at 1108. As the Commission stated in the FY2010 ACD, a finding that **a product or class** fails to satisfy a provision of title 39, including the cost coverage factor of 39 U.S.C. § 3622(c)(2), **does not compel a finding of noncompliance**. FY2010 ACD at 17. [Docket No. ACR2010-R, Order No. 1427, p. 14 (emphasis added).]

In no way can this general policy discussion concerning section 101(d) in general be read to contradict the Commission’s express finding with respect to Standard Flats. Indeed, in that same Order, the Commission clarified why it issued a remedial order for Standard Flats, and only for Standard Flats:

By contrast, in the case of **Standard Mail Flats**, the **Postal Service failed to take remedial action** notwithstanding repeated Commission admonitions that steps need to be taken to address the cost coverage shortfall. The Postal Service’s failure to address the continuing intra-class cross subsidy **caused other Standard Mail users to complain** about the rate preference accorded mailers of Standard Mail Flats, i.e., an inequitable distribution of burdens compelling them to subsidize others’ mailings. As noted, in this instance, the **shortfall was significant, growing, longstanding, expected to increase, creating significant adverse impact on others, and had not been addressed or explained by the Postal Service**. The Commission responded by directing the Postal Service to devise a plan to increase Standard Mail Flats revenues or decrease its costs so as to eliminate this problem. Under the circumstances, **this action was entirely appropriate**. [*Id.*, p. 20 (emphasis added).]

It would be virtually impossible to misunderstand what the Commission was saying. Using the Commission’s general policy statement as a refutation of its specific remedial order is utterly

baseless, further evidencing the Postal Service's spirit of resistance to lawful Commission Orders and inquiries.

In fact, even after losing its court challenge to the Commission's authority to find that Standard Flats pricing was illegal and to issue remedial orders in Docket No. ACR2010,⁴⁷ the Postal Service in its current ACR has actually ratcheted up its rhetoric against the Commission's authority beyond anything that it previously filed:

- When discussing any schedule involving future prices, it is important to consider two factors. First, any proposed rate schedule is speculative, because it relies on numerous assumptions (*i.e.*, anticipated market conditions) that may or may not materialize. Second, **only the Postal Service's Governors have the authority to change prices** of postal products.... Pricing decisions are based upon the application of statutory and regulatory requirements, taking into consideration the **Governors' independent evaluation** of market and business strategy concerns. [FY 2012 ACR, p. 16 (emphasis added).]
- [S]trict adherence to above-CPI price increases also impairs the **pricing flexibility the Postal Service is guaranteed** under the PAEA.... An unquestioning implementation of above-CPI price increases would also significantly restrict the Postal Service's ability to react to changing market and strategy considerations. In short, **forcing** the Postal Service to use more of its limited pricing authority on Standard Mail flats (irrespective of the **judgment of the Governors and Postal Service management**) is **inconsistent with the balance of authorities** embodied in title 39. [*Id.*, p. 18 (emphasis added).]
- In developing this schedule, the Postal Service was mindful to balance its need to maintain **pricing flexibility**⁴⁸.... The PAEA contemplates that

⁴⁷ See U.S. Postal Service v. Postal Regulatory Commission, *supra*.

⁴⁸ In repeated invocation of the term "pricing flexibility," the Postal Service apparently believes that uses of that term as an "objective" in 39 U.S.C. section 3622(b)(4) and as a "factor" in 39 U.S.C. section 3622(c)(7) trumps all other provisions of PAEA. It does not. As the Commission advised the court: "that flexibility must be 'consistent with the overarching financial and policy goals set forth' in the PAEA, S. Rep. No. 108-318, at 8,

many factors and considerations must be balanced, and it places that thoughtful balancing **in the hands of the Governors**. While the **Postal Service may choose** to implement the schedule [presented] without further revision, changes in market conditions and other strategic concerns may require subsequent adjustments. [*Id.*, p. 19 (emphasis and footnote added).]

In support of its contention that “strict adherence to above-CPI price increases also impairs the pricing flexibility the Postal Service is guaranteed under the PAEA,” the Postal Service leans heavily on the following excerpt from the comments of Commissioner Taub dissenting from the Commission’s rejection of Postal Service noticed Standard Mail rates in Docket No. R2013-1: “the Postal Service is responsible for selecting the set of rates which, in its judgment, is most consistent with its statutory mission.”⁴⁹ The Postal Service’s excerpt from the Taub dissent is quite unfaithful to the context. The entire paragraph of the Taub dissent reads as follows, with the words quoted by the Postal Service in italics:

In contrast, in the revised statute, the authority to establish reasonable and equitable classes of mail and rates of postage is vested **primarily** in the Postal Service. The legislative history and structure of the act support this revised view. While the **contours** of a modern system of regulation must be **determined by the Commission**, it would be inappropriate for the Commission to assume its former role of selecting from among a spectrum of lawful rates and classifications the set of rates which is, in its judgment, most consistent with statutory criteria. In its new role of regulator rather than rate maker, the function of the Commission is to **define the spectrum of lawful rates**. Within this spectrum, *the Postal Service is responsible for selecting the set of rates which, in its judgment, is most consistent with its statutory mission*. The **Commission may reject a given rate or classification as unlawful**, but it

including the policy that ‘[p]ostal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis.’ 39 U.S.C. § 101(d).” Brief for Respondent Postal Regulatory Commission, p. 31, *USPS v. PRC*, *supra*.

⁴⁹ Dissent of Commissioner Taub, Order No. 1541, Docket No. R2013-1 (Nov. 16, 2012), p. 4, http://www.prc.gov/Docs/85/85662/Order_1541.pdf.

should no longer recommend rates and classifications except in the most extraordinary cases. [Emphasis added.]

The Postal Service nowhere acknowledges any of the context of the sentence fragment extracted from Commissioner Taub’s dissent, that: (i) pricing authority is only “primarily,” not exclusively, vested in the Postal Service; (ii) the Commission may reject a given rate as unlawful, which constrains Postal Service pricing flexibility; (iii) the contours of lawful rates are determined by the Commission, not the Postal Service; and (iv) only within the spectrum of lawful rates established by the Commission can the Postal Service determine prices. Read in context, Commissioner Taub’s dissent provides no support for the Postal Service’s contention that, even as a statutory monopoly, it has unregulated discretion to set prices.⁵⁰

The only conclusion that can be drawn from these bold assertions is that the Postal Service truly believes that PAEA vests in the Governors all pricing decisions, and that the Governors have the statutory authority to overrule Commission remedial orders. In doing so, the Postal Service rejects wholesale the Commission’s critical role in the current statutory postal pricing scheme.

- 39 U.S.C. section 3622 — the Postal Regulatory Commission’s establishing a “modern system for **regulating rates** and classes for market-dominant products.” (Emphasis added.)

Note that by using the word “regulating” rates and classes, PAEA describes the **role of the Commission** — not the role of

⁵⁰ Commission Taub confirmed this reading in his concurring opinion in Order No. 1573: “In its new role of regulator rather than ratemaker, the function of the Commission is to define the spectrum of lawful rates. Within this spectrum, the Postal Service is responsible for selecting the set of rates which, in its judgment, is most consistent with its statutory mission. The Commission may *reject* a given rate or classification as unlawful, but it should no longer *recommend* rates and classifications except in the most extraordinary cases.”

the Postal Service which obviously cannot regulate itself. The Postal Service denies to the Commission this statutory role as the regulation of rates.

- 39 U.S.C. section 3652 — which requires the **Postal Service** to “prepare and submit to the Postal Regulatory Commission” a detailed report “in sufficient detail **to demonstrate** that all products during such year complied with all applicable requirements of this title....” (Emphasis added.)

Note that the Postal Service **must demonstrate compliance** with “all applicable requirements of” Title 39 **to the Commission**. The Postal Service bears the burden of proof, and the Commission is the regulator of rates to ensure they comply with Title 39. The Postal Service appears to demand that the Commission abandon this statutory duty.

- 39 U.S.C. section 3653(a) and (b) — which **requires the Commission to issue a “Determination of compliance or noncompliance”** as to “whether **any rates or fees** in effect during such year (for products individually or collectively) were not in compliance with applicable provisions of this chapter (or regulations promulgated thereunder)....” (Emphasis added.)

Note that the Commission is charged with a duty to **evaluate** the Postal Service’s rates and publish its “determination” as to whether those rates are lawful or unlawful. There is no hint that the Postal Service’s judgment as to pricing is not reviewable by the Commission.

For both FY 2010 and FY 2011, the Commission found noncompliance of Standard Flats prices with 39 U.S.C. section 101(d) — which requires that “Postal rates shall be established to apportion the costs of all postal operations to all users of the mail on a **fair and equitable** basis.” (Emphasis added.) FY 2010 ACD, p. 106.

- 39 U.S.C. section 3653(c) — whenever the Commission makes a “written determination of noncompliance” the Commission “**shall take appropriate action** in accordance with subsections (c) and (e)⁵¹ of section 3662 (as if a

⁵¹ As there is no subsection (e), this reference is understood to be a typo, actually referencing subsection (d).

complaint averring such noncompliance had been duly filed and found under such section to be justified).” (Emphasis added.)

Note that a finding of noncompliance triggers a **statutory requirement** that the Commission take appropriate action.

- 39 U.S.C. section 3662(c) — “Action required if complaint found to be justified.--If the Postal Regulatory Commission finds the complaint to be justified, it **shall order that the Postal Service take such action** as the Commission considers appropriate **in order to achieve compliance** with the applicable requirements and to **remedy the effects of any noncompliance** (such as **ordering unlawful rates to be adjusted to lawful levels**, ordering the cancellation of market tests, ordering the Postal Service to **discontinue providing loss-making products**,⁵² or requiring the Postal Service to make up for revenue shortfalls in competitive products).” (Emphasis added.)

Note that a finding of noncompliance triggers a **statutory requirement** that the Commission “order ... the Postal Service [to] take such action as the Commission considers appropriate” both “to achieve compliance” and “to remedy the effects of any noncompliance.” There is no hint that the Postal Service may disregard such an order even if it disagrees with it.

- 39 U.S.C. section 3662(d) — “(d) Authority to order fines in cases of deliberate noncompliance.--In addition, in cases of **deliberate noncompliance** by the Postal Service with the requirements of this title, the Postal Regulatory Commission **may order**, based on the nature, circumstances, extent, and seriousness of the noncompliance, **a fine** (in the amount specified by the Commission in its order) for each incidence of noncompliance. Fines resulting from the provision of competitive products shall be paid from the Competitive Products Fund established in section 2011. All receipts from fines imposed under this subsection shall be deposited in the general fund of the Treasury of the United States.” (Emphasis added.)

⁵² Interestingly, the Postal Service recently admitted that “the **rational response** [to a product that perennially loses money] **would be to terminate the money-losing product** and raise prices on the money-making product.” Docket No. ACR2011, Postal Service Reply Comments, p. 5 (emphasis added). The Postal Service’s Reply Comments failed to note that elimination of the deficit on underwater products might obviate or mitigate the need to increase prices on profitable products.

Note that Congress anticipated that the regulated Postal Service might resist the Commission's remedial orders, and engage in "deliberate noncompliance," and that it gave the Commission the power to impose a monetary fine, at its discretion, on the Postal Service.

- 39 U.S.C. section 3664 — "Enforcement of orders. The several district courts have jurisdiction specifically **to enforce, and to enjoin and restrain the Postal Service from violating**, any order issued by the Postal Regulatory Commission." (Emphasis added.)

Note that the Commission's remedial orders, enforceable in federal district court, have supremacy. This authority is further strengthened by the court's contempt powers.

In its response to ChIR No. 4, question 1, the Postal Service somewhat backed off its challenge to the Commission's authority to issue remedial orders, but not entirely. While the Postal Service denied that it takes the position that the Governors' pricing authority can be exercised in disregard Commission remedial orders, the Postal Service continued to state that "it could be breach of [the Governors'] fiduciary duties" to approve certain prices, and that the Governors needed to conduct an "independent evaluation of market and business strategy concerns." Response to Question 1a. And then, "it would be speculative to predict with certainty any future pricing action by the Governors." Response to Question 2b. Again, yet, and still, the Postal Service preserves its wiggle room ("pricing flexibility"), enabling it to evade compliance as it chooses — well short of simply recognizing the Commission's final statutory authority over pricing.

The lesson of a review of the Postal Service's ACR and responses to ChIR's is that any further remedial order for Standard Flats must be extraordinarily specific, and cannot rely on the Postal Service's good-faith compliance. Once such a specific order is issued, any violation

of that order will certainly require the Commission to use the powers, set out above, in 39 U.S.C. sections 3662(d) and 3664, to order a fine or by initiating an action in U.S. District Court to compel the Postal Service to obey such specific remedial orders.

C. Postal Service's 3-Year Schedule of CPI*1.05 Increases Filed in FY 2012 ACR is Inadequate.

The Postal Service's FY 2012 ACR responded to the FY 2010 ACD and Order No. 1427 to provide a schedule of above-CPI price increases, but provided only three years of increases. The schedule provided was insufficient for three reasons: the increases are barely noticeable, a three-year period is inadequate, and without approval from the Board of Governors, the schedule is completely meaningless.

First, the Postal Service's schedule of above-CPI price adjustments provides for increases at 105 percent of the price cap. The schedule of Standard Flats price increases provided in response to ChIR No. 4, question 3, are only 0.08 percentage points above the price cap for the three years provided. The assumption that unit costs will remain the same has no basis in history, as unit costs have only increased under PAEA. Assuming unit costs increase at the rate of inflation,⁵³ then those costs will increase more than unit revenues because they are higher. Using the Postal Service's table provided in response to ChIR No. 4, question 3, if costs increase at the rate of inflation, then the unit loss increases (and cost coverage remains about the same).

⁵³ The question that Valpak had asked the Commission to direct to the Postal Service assumed that costs would increase at the rate of inflation. *See* Valpak Motion for Issuance of Information Request, question 3.

Table III-3
Projected Unit Revenue, Costs, and Contribution
Based on USPS Response to ChIR No. 4, Q. 3
(with costs adjusted by inflation)

Year	CPI Price Cap	Standard Flats Price Increase	Unit Revenue	Unit Attributable Cost	Unit Contribution
FY 2013	2.57%	2.62%*	0.388*	0.477	-0.089
FY 2014	1.57%	1.65%	0.394	0.484	-0.090
FY 2015	1.66%	1.74%	0.401	0.492	-0.091
FY 2016	1.57%	1.65%	0.408	0.500	-0.092

* “Actual increase and projected unit revenue from Docket No. R2013-1 price change.”

Second, reporting for only three years mask an important truth. Even if the Postal Service’s assumptions about unit costs are accurate, by FY 2016, the cost coverage for Standard Flats will be only about 87.7 percent. At that pace, it will take another seven years, requiring a total of **11 years** (*i.e.*, by FY 2023), for Flats to achieve cost coverage. This timetable is not compatible with the FY 2010 ACD’s directive to “move as promptly as practicable to eliminate this inequity.” *Id.*, p. 107.

Third, in response to ChIR No. 4, question 2.b, the Postal Service admitted “The Governors did not approve the three-year schedule of above-CPI price increases for Standard Mail Flats presented in Table 3 of the Annual Compliance Report.” No doubt, the Commission thought that the schedule it ordered would allow some flexibility because it ordered it to be “updated with each subsequent” price adjustment, but it certainly did not view it as completely meaningless. With the various qualifications the Postal Service has presented with the schedule, it appears that the Postal Service merely presented this as pro forma

compliance, but without the Governors' approval, or even review of some sort, one is left to wonder about the point of the exercise.

D. The Commission Should Find Standard Mail Flats to Be Out of Compliance and Issue again a More Detailed Remedial Order in this Docket to Avoid Continuation of the Problem of Postal Service Resistance.

Standard Mail Flats prices were out of compliance in FY 2012, as they were at the time of the Commission's findings of noncompliance in FY 2010 and FY 2011. *See* section III.A, *supra*. The Postal Service's contribution risk model fails to justify different treatment this year, and indeed, demonstrates the opposite — that greater increases should be imposed on Standard Flats. *See* sections IV-V, *infra*. It is imperative that the Commission make another finding of noncompliance for Standard Flats.

A finding of noncompliance must be followed by the imposition of a stronger remedial order on the Postal Service. *See* 39 U.S.C. §§ 3653(c) and 3662(c). The Commission's remedial order in the FY 2010 ACD was the first one ever issued under PAEA. PAEA provided only minimal guidance to the Commission, leaving much of it up to the Commission's discretion based on its expertise. The Postal Service has demonstrated over the past two years that the Commission cannot expect good-faith compliance. For the reasons set out in section III.A, only minimal, "technical," or pro forma compliance can be expected, and therefore, any Commission remedial order must set the bar high enough that minimal compliance will actually result in a meaningful remedy.

The FY 2010 ACD was trying to be reasonable by attempting to achieve compliance by ordering above-CPI price increases, believing the Postal Service would cooperate. For example, that order stated, "In requiring the Postal Service to take remedial action, the

Commission does not impose a specific deadline. However the Postal Service should move as promptly as practicable to eliminate this inequity.” *Id.*, p. 107.

Unfortunately, the Postal Service has resisted at every step eliminating the inequity of the Standard Flats cross-subsidy. The Postal Service cannot be relied upon to take on the task of achieving compliance with a “light-handed” approach. Unless the Commission is more specific in its remedial order, the Postal Service will use every opportunity to push back against the Commission. Valpak asks for entry of the remedial order proposed at the end of Section VI, *infra*.

IV. THE CHRISTENSEN ASSOCIATES STANDARD MAIL RISK ANALYSIS DEMONSTRATES THAT STANDARD FLATS PRICES SHOULD BE INCREASED FAR BEYOND WHAT THE POSTAL SERVICE HAS DONE OR PROPOSED.

Even after losing its appeal from the Commission’s FY 2010 ACD,⁵⁴ the Postal Service continues to challenge the legitimacy of the Commission’s remedial order that, *inter alia*, Standard Flats prices be increased above CPI until revenues cover costs. *See* FY 2010 ACD, pp. 15-16, 103-07; FY 2011 ACD, pp. 13-16, 113-19. The Postal Service’s justification for its refusal to obey the Commission order is that it “believes that continued above-CPI price increases for the Flats product could impair the Postal Service’s ability to enhance its revenue and contribution in the long run.” FY 2012 ACR, pp. 16-17. The basis for that belief is explained as follows: “The financial risk inherent in the Commission’s pricing directives is

⁵⁴ *See U.S. Postal Service v. Postal Regulatory Commission*, 676 F.3d 1105 (D.C. Cir., 2012).

illustrated in the models presented in USPS-FY12-43” which “were produced by Christensen Associates.” *Id.*, p. 17.

A. The Christensen Associates Model Assesses Risks to Contribution Associated with Increasing Various Prices.

The Christensen Associates study consists of a narrative “Scenario Analysis for Standard Mail Contribution” (Dec. 27, 2012), accompanied by a series of models embodied in spreadsheets. USPS-LR-FY12-43. That study discusses the effect of different Standard Mail pricing scenarios on Postal Service contribution under the PAEA price cap. Specifically, it addresses problems associated with pricing deeply underwater Standard Flats, when that product’s volume is in systemic decline “due to trends in demand that are autonomous or *independent of price changes.*” *Id.*, p. 1, n.1 (italics original). Christensen Associates describes the context of its study, as follows:

In Docket No. R2013-1, the Postal Service claimed that in the face of **systemically declining volume** for one product [Standard Flats] and relatively **more stable volume** for another product (or group of products) [All Other Standard Mail], applying limited price cap authority to the first product at the necessary expense of the second product (or group of products) **can reduce** overall **contribution**, especially in the long run. [*Id.*, p. 1 (emphasis added).]

After explaining that both Valpak and the Public Representative urged above-CPI increases for Standard Flats, Christensen Associates then seeks to support the supposed legitimacy of the Postal Service’s rationale for disregarding the Commission’s remedial order that the Postal Service give an above-CPI increase to Standard Flats in the January 27, 2013 price adjustment (Docket No. R2013-1). The introduction summarizes the main point of the study:

To the extent that a product's **volume autonomously declines** after a price change under the backwards-looking price cap, then **some** of the revenue and contribution that the Postal Service would have expected to earn under stable volumes will not actually be realized. Indeed, **if** the decline is not transient, then the **pricing authority** associated with the volume drop is **permanently lost**. [*Id.*, p. 1 (emphasis added).]

Christensen Associates acknowledges that its study would **not** help the Postal Service develop prices which **maximize contribution**. Rather, it only seeks to demonstrate that there may be **risks** associated with a pricing strategy which increases prices too much and too rapidly for products already experiencing a sharp decline in volume, at the expense of increased prices for other products.

[S]even contribution models for Standard Mail are being filed [but it] should perhaps be emphasized that these are **not models of optimal pricing paths**. Rather, they are **risk analyses**. They are intended to show that contribution **can be** reduced in the long run if **limited price-cap space** is dedicated to a product in **systemic volume decline**. Improving contribution for any given product — even a product that generates negative contribution — over time **could** very well **harm the overall finances** of the Postal Service, **given price-cap constraints**. [*Id.*, p. 2 (emphasis added).]

These seven contribution models are presented in the form of linked spreadsheets that span eight years. In its general discussion about the perceived virtues of restraining price increases on underwater products, the Christensen Associates study states that:

The case of [underwater] **Standard Mail Flats** requires consideration of the situation when [a product] has **negative contribution** (over volume-variable or marginal cost). In this case, the logic ... is upended, as **the expected cost reductions from the loss of volume would be expected to exceed the loss of revenue and thus improve the net income** of the Postal Service. It may be tempting to conclude that applying above-inflation price increases to the loss-making product would

similarly be virtuous, or at least clearly harmless. [*Id.*, p. 2 (emphasis added).]

The models submitted by Christensen Associates in this docket admittedly contain some improvements over similar models filed by the Postal Service in its Reply Comments in Docket No. R2013-1 (which were criticized by the Commission⁵⁵):

One improvement is ... that the studied **tradeoff** is no longer just Standard Mail Flats vs. Letters. Instead, it is expanded to **Flats** vs. **All Other** Standard Mail. This accounts for all authority under the Standard Mail price cap. [*Id.*, p. 3 (emphasis added).]

All comparisons in all models are thus between (i) Standard Flats and (ii) All Other Standard Mail (“All Other”). The way that the models are set up and the procedure used by Christensen Associates to demonstrate its desired result are as follows:

The models, as filed, each compare two scenarios. In **Scenario 1**, the Standard Mail Flats product receives a **2.62 percent** price increase in Year 1 (the R2013-1 change) and increases at the inflation/price cap rate thereafter. The alternative **Scenario 2** modifies Scenario 1 by specifying **above-inflation** increases for Standard Mail Flats in some of the early years. [*Id.*, p. 3 (emphasis added).]

It is important to note the plethora of qualifications which Christensen Associates puts on its study. One must search for any statement on which a decision could be made with confidence, as the report is stated in terms of **possibilities**, and Valpak will concede, as they say, that “anything is possible.” For example:

- P. 1, para 1. Applying greater limited price cap authority to Standard Flats “**can** reduce overall contribution.”

⁵⁵ See Docket No. R2013-1, Order No. 1541 , pp. 39-41 (Nov. 16, 2012), http://www.prc.gov/Docs/85/85662/Order_1541.pdf.

- P. 1, para 2. Autonomous volume declines after a price increase **can** cause “some of the revenue and contribution” not to be realized.
- P. 1, para 2. Divergent volume trends “**can**” lead to lower contribution.
- P. 2, para. 2. Loss of contribution from one product “**can**” outweigh the gains from the price increase on the other product.
- P. 2, para. 3. Improving contribution for one product “**could**” harm the overall finances of the Postal Service.
- P. 3, para. 2. These inputs constitute a scenario and “**not a forecast.**” [Emphasis added.]

Although Christensen Associates hypothesizes **possibilities** which support the Postal Service’s existing pricing choices, it ignores the **certainty** of losses from Standard Flats — which now have totaled \$2.616 billion over the past five years, and which assuredly will continue much higher if price increases are restrained to CPI. *See* section IV.C, *infra*.

Further, although Christensen Associates fears that increasing Standard Flats prices too far too fast could result in reduced contribution, it does not inform us where that maximum price path lies over the eight years spanned by its models.

Moreover, in making its comparisons, Christensen Associates focuses **exclusively** on how the two scenarios being compared could **affect contribution** over an eight-year period. In so doing, Christensen Associates elects to ignore completely other pertinent considerations, such as:

- the **illegality** of underpricing of Standard Flats in violation of 39 U.S.C. section 101(d), as previously determined by the Commission in both FY 2010 ACD and FY 2011 ACD;
- the **illogic** of placing the health of catalog mailers above the financial health of the Postal Service;

- the **inequity and inefficiency** of compelling some advertising mailers to continue to cross-subsidize those who elect to advertise via catalogs; and
 - the **effect** on the competitive positioning of the five **Other Standard Mail Products** as a result of continued compelled subsidization of Flats.
- B. The Christensen Associates Model Purports to Show that a Divergent Secular Decline in Flats Can Outweigh the Expected Gain in Contribution from Loss of Underwater Volume.**

The Christiansen Associates study uses two scenarios in each of several models:

- **Scenario 1** assumes that Standard Mail Flats receive a **2.62 percent** price increase in Year 1 (as was done in the Docket No. R2013-1 change, effective Jan. 27, 2013), and increases at CPI thereafter. This resembles a pricing path that the Postal Service might advocate.
- **Scenario 2** assumes that Standard Mail Flats receive a higher-than-CPI increase in the early years:
 - the **V1** model assumes a **5 cent** (nominal) increase in Standard Flats for two years, followed by CPI increases, resembling a pricing path advocated by Valpak.
 - the **V2** model imposes a **5.373 percent** price increase in excess of CPI for three years, followed by CPI increases, resembling a pricing path advocated by the Public Representative.

1. Version 1c. This critique of the various Christensen Associates models begins with the Version labeled “c” (as in Spreadsheet “StdPerspectiveV1c,” called herein “Version 1c”). In this version of the model, both products have 100 percent cost elasticities (volume variability). *Id.*, p. 4. The effect of divergent secular trends is neutralized by assuming that the volume of **Flats** and **All Other** both **decline at a steady rate** of -2.0 percent per year, as shown under the first tab, Assumptions. Even if the steady downward trend of -2.0 percent for both Flats and All Other assumed some alternative common decline (*e.g.*, -3.0 percent, -1.0

percent, or even zero), the effect vis-a-vis comparing the contribution from Scenarios 1 and 2 would be similar.

In Version 1c, the net effect of neutralizing divergent secular trends can be seen graphically under tab “Contribution Summary.” As shown there, **increasing the price of Standard Flats** relative to **All Other** (*i.e.*, as in Scenario 1, but not Scenario 2) clearly and unambiguously **results in greater contribution** for the Postal Service. Contribution rises steadily throughout the entire eight-year period covered by the models. This result is duly reported, and the conclusion drawn is as follows:

Scenario 2 does improve on Scenario 1, with **\$643 million more in total contribution** over eight years than Scenario 1. This reversal from Version 1a given **otherwise identical input parameters** points to the **divergent volume trends** as a factor in determining whether increasing prices for certain products above the cap will improve both the cost coverage of the products and the overall finances of the Postal Service. [*Id.*, p. 5 (emphasis added).]

Moreover, the same would be true under the Christensen Associates study, whenever the autonomous **decline in the volume of Standard Flats** should ever begin to **taper off**. At that time, higher contribution and improved financial health of the Postal Service will result from **increasing the price** of Standard Flats.

2. Version 1a. Turning now to Version 1a, Christensen Associates explains:

the autonomous volume **declines for Standard Mail Flats are assumed to exceed** those for other Standard Mail. The initial values are based on the average rates of volume change from FY2009 through FY2012. Accordingly, the independent annual volume growth rates have been updated to reflect the averages from FY 2009 to FY 2012, **-8.7 percent for Flats** and **-0.5 percent for All Other**. [*Id.*, p. 3 (emphasis added).]

The rather sharp differences in the secular decline in Standard Flats versus All Other in Version 1a appear to be of sufficient magnitude to satisfy the Christensen Associates requirement that volume trends diverge by a meaningful amount. The pricing assumptions in Scenarios 1 and 2 are explained as follows:

In **Scenario 1**, the Standard Mail Flats product receives a 2.62 percent price increase in Year 1 (the R2013-1 change) and increases at the inflation/price cap rate thereafter. The alternative **Scenario 2** modifies Scenario 1 by specifying above-inflation increases for Standard Mail Flats in some of the early years. The “V1” models implement **5 cent** (nominal) increases in Flats revenue per piece in the first two years, followed by increases at inflation.... These scenarios are based on alternative pricing paths **presented in Valpak** and Public Representative comments from Docket No. R2013-1. [*Id.*, p. 3 (emphasis added).]

When Scenarios 1 and 2 are compared in Version 1a, the results are presented in the spreadsheet’s “Contribution Summary” tab. According to Christensen Associates:

In the eight-year span, total (cumulative) contribution is \$54.597 billion from Scenario 1 and \$54.340 billion from Scenario 2. The difference is **\$257 million** in favor of Scenario 1 — which features the lower price increases for Flats. For a short while, the Scenario 2 prices yield slightly higher total contribution, but eventually the lower price levels for All Other Standard Mail reduce the total contribution below Scenario 1. This happens despite a Scenario 2 price premium for Flats only in Years 1 and 2; in Years 3 through 8 the price increases are at the cap as in Scenario 1. This shows that even a temporary (two-year) attempt to improve the Flats cost coverage can *permanently* reduce total contribution. [*Id.*, p. 4 (emphasis added).]

Two points stand out in this summary.

First, the possible difference in the cumulative **eight-year** contributions of \$54.597 billion and \$54.340 billion (or \$257 million) is only **0.47 percent** of Standard Mail contributed by both; *i.e.*, less than one-half of one percent of Standard Mail revenues over eight years.

(By way of contrast, the certain losses from Standard Flats over the last **five years** (from FY 2008-2012) have been **10 times** that amount — \$2.616 billion.)

Second, the two contribution streams differ over the long eight-year period. Scenario 2 brings in more contribution in the early years, when the Postal Service need for revenue is great. Also, the Christensen Associates study makes **no effort to discount to present value**.

Yet, on the basis of this 0.47 percent undiscounted difference in estimated contribution, Christensen Associates indicates a preference for the pricing in Scenario 2, which reflects continued low coverage on Flats, along with continued losses and an additional cross-subsidy of \$2.7 billion during those eight years. If Christensen Associates believes this scenario demonstrates conclusively the folly of trying to raise the price of Standard Flats to a coverage that exceeds 100 percent, at least within the eight years covered by the model, it would be wrong.

C. Christensen Associates' Own Model Yields a Markedly Superior Result when the Price of Standard Flats Is Increased Steadily.

As noted previously, Christensen Associates states that “these are not models of optimal pricing paths.” *Id.*, p. 2. Nor does Christensen Associates provide any indication as to how one might go about determining an optimal pricing path. At the same time, the models are designed so that one can:

vary the inputs, including rates of inflation (the price cap), rates of cost inflation, own price and attributable cost elasticities, and **amounts by which Standard Mail Flats prices are raised relative to the cap.** [*Id.*, p. 3 (emphasis added).]

Because inputs can be varied, the model can be used to examine two important questions with respect to above-cap increases in the rate for an underwater product such as Standard Flats:

- How large a price increase on Standard Flats is too large?
- How fast a price increase on Standard Flats is too fast?

Taking Version 1a as presented, with the autonomous declines in Standard Flats exceeding those of All Other, and **leaving unchanged all other parameters specified by Christiansen Associates**, such as rate of inflation, elasticities, etc., Valpak has tested whether “Scenario 1 — which features the lower price increases for Flats” — is indeed better for Postal Service finances than a pricing strategy that aims to lift the coverage of flats above 100 percent within, at most, a few years.

Changing only the prices of Standard Flats in Version 1a, Valpak has determined (through an iterative process) that a pattern of fairly steady **above-CPI increases** in the price of Standard Flats **improves Postal Service contribution** and finances even **more than Scenario 1**. The price increases relative to the price cap — *i.e.*, above the cap in Scenario 2 — are shown in column 2 of Table IV-1⁵⁶:

⁵⁶ In the spreadsheet for Version 1a, under tab “Assumptions,” replace the Flats price premium shown under Scenario 2 with the premiums shown here. Substituting these price increases into Scenario 2 Version 2a will produce the same result.

Table IV-1

Using the Christensen Associates Model to Identify a Superior Price Path to Higher Contribution

<u>Year</u> (1)	Scenario 2 Standard Flats Price Premium over CPI (%)
	(2)
1	3.00
2	2.00
3	2.50
4	3.50
5	8.00
6	4.50
7	4.50
8	6.00

For clarity, results of Christensen Associates' Version 1a, but inserting the above price adjustments under "Scenario 2" in the spreadsheet, will be referred to here as "**Scenario 3.**"

In Scenario 3, over eight years the cumulative contribution increases to \$54.670 billion, versus the \$54.597 billion for Scenario 1, and actually **exceeds the contribution in Scenario 1 by \$73 million.** If one follows Christensen Associates' exclusive choice criterion — *i.e.*, an exclusive focus solely on contribution — that alone makes the pricing in Scenario 3 superior.

The various scenarios in USPS-LR-FY12-43 are hypotheticals, each based on a number of assumptions intended to reflect current reality, hence the results were offered to reflect outcomes that should receive serious consideration. If the Christiansen Associates models are employed, then it is necessary to compare other pertinent aspects of the pricing strategies in Scenarios 1 and 3. Specifically, we examine after-rates coverage, volumes, and contribution

for Standard Flats and All Other. The results are shown in Tables IV-2 (for Standard Flats) and IV-3 (for All Other).

1. Standard Flats (Table IV-2). In Christensen Associates' **Scenario 1**, price increases just equal to the rate of inflation mean that coverage of Standard Flats improves painfully slowly, going from 82.8 percent at the end of Year 1 to 86.1 percent at the end of Year 8. **Inflation** is assumed to be **2.57 percent** annually, while **factor input costs** are assumed to increase at only **2.0 percent** annually. It is as a result of this highly optimistic — if not totally unrealistic — assumed differential that coverage increases gradually. Extrapolating, Standard Flats would appear **to reach 100 percent coverage in approximately 40 years**. Such a low coverage means that Standard Flats will continue being deeply underwater, accumulating an **additional cumulative \$2.7 billion deficit over the eight-year period**, and of course, requiring an additional cross-subsidy from other mailers. The volume of Standard Flats exhibits a gradual decline, most of which is attributable to the autonomous secular decline.⁵⁷ At the end of Year 8, the volume of Standard Flats is 3,793 million pieces.

However, in **Scenario 3**, coverage of Standard Flats is seen to improve steadily. Coverage exceeds 100 percent in Year 5 and continues growing to 120 percent by the end of Year 8. Contribution likewise improves steadily. During the first four years,

⁵⁷ In Scenario 1, the price of Standard Flats increases at the same rate as inflation. That is, there is no relative price increase, and the assumed price elasticity for Standard Flats has minimal effect.

contribution is still negative, but in **the last four years contribution is positive** and grows to \$330 million in Year 8.

Over the entire eight-year period, **the cumulative loss in Scenario 3 is a relatively modest \$267 million — a tenth of the \$2.7 billion loss in Christensen Associates' preferred Scenario 1.** Even if the statute is read not to require that each product cover its attributable cost, as a matter of both equity and sound business practice, Scenario 3 is preferable because it phases out the cross-subsidy burden on All Other profitable products, and drives out more quickly those Standard Flats that cannot afford to pay their attributable cost. As a result of increased prices for Standard Flats in Scenario 3, volume declines more than in Scenario 1, to just over 3 billion pieces in Year 8. At this point, under Scenario 3, the Postal Service has achieved a moderately profitable product that finally, after being underwater for many years, is beginning to make a reasonable contribution to fixed overhead costs. From the vantage point of risk analysis, transforming Standard Flats into a profitable product that makes a meaningful contribution to overhead would seem far less risky than assuming the burden of carrying a major money-losing product for decades. Thus, the Christensen Associates study does not support the Postal Service's desire to continue its extensive cross-subsidies to Standard Flats.

Table IV-2**Standard Flats Coverage, Contribution and Volume****A. Scenario 1**

Year	Coverage	After Rates Contribution (\$, millions)	After Rates Volume (millions)
1	82.8%	-433	5,424
2	83.3%	-392	4,954
3	83.8%	-358	4,558
4	84.2%	-333	4,285
5	84.7%	-317	4,113
6	85.2%	-303	3,990
7	85.7%	-291	3,870
8	86.1%	-281	3,793

B. Scenario 3

Year	Coverage	After Rates Contribution (\$, millions)	After Rates Volume (millions)
1	85.3%	-363	5,326
2	87.5%	-284	4,807
3	90.2%	-206	4,356
4	93.9%	-121	4,009
5	102.0%	36	3,664
6	107.2%	127	3,458
7	112.6%	215	3,263
8	120.0%	330	3,083

2. All Other (Table IV-3). In Scenario 1, the lower price adjustments imposed on Standard Flats force an increase in the coverage of All Other, from 174.9 percent to 181.9 percent. The model assumes a slightly positive secular trend for All Other, and volume therefore increases from 73,515 to 76,125 million pieces, despite the higher coverage imposed.

The model aside, in the real world in which the Postal Service operates, the private sector is endeavoring to divert some of the most profitable products in All Other (*e.g.*, High Density/Saturation Flats & Parcels), and it is unclear whether increasing the price of All Other products in order to subsidize Standard Flats will enable the Postal Service to maintain the volume of these very profitable products. Currently, the Postal Service is said to be losing volume of highly profitable free-standing inserts to private sector competitors. *See* USPS Notice of Filing (Apr. 30, 2012), Docket No. MC2012-14/R2012-8, p. 3. To help stem the decline in the volume of Free Standing Inserts, the Postal Service has negotiated, with Valassis, an NSA that offers a “more competitive price,” along with a somewhat lower profit margin, than the full-tariff High Density Saturation product.⁵⁸ In any event, forcing an increased coverage on All Other in Scenario 1 certainly does nothing to increase competitiveness of those five products.

Alternatively, in Scenario 3, coverage of All Other Standard products remains essentially unchanged over the eight-year period, at around 175 percent. Although coverage at that level may not increase Postal Service competitiveness, it should not harm it, as is the case in Scenario 1. Being less competitive always should be viewed as more risky than being more competitive, and in this respect the Christensen Associates model can help provide a useful risk analysis. At the end of Year 8 in Scenario 3, the **volume of highly profitable All Other Standard products has**

⁵⁸ Describing the price offered to Valassis as “more competitive” can be seen as an implicit acknowledgment that the general tariff rate for High Density and Saturation Flats is “less competitive.”

increased by over 1.2 billion pieces in comparison to Scenario 1. The extra growth in volume may not be huge, but it certainly leaves the Postal Service in a stronger position vis-a-vis its competitors than does Scenario 1 — *i.e.*, the Postal Service is positioned with more volume of highly profitable products and a more competitive price for those products. Thus, not only on the basis of greater contribution, but also based on sound business judgment with respect to these additional considerations, Scenario 3 should be seen as indisputably preferable to Scenario 1.

Table IV-3**All Other Standard Mail Products Coverage, Contribution and Volume****A. Scenario 1**

Year	Coverage	After Rates Contribution (\$, millions)	After Rates Volume (millions)
1	174.9%	6,306	73,515
2	175.9%	6,485	73,169
3	176.9%	6,634	72,437
4	177.9%	6,922	73,162
5	178.8%	7,293	74,625
6	179.9%	7,609	75,371
7	180.9%	7,859	75,371
8	181.9%	8,197	76,125

B. Scenario 3

Year	Coverage	After Rates Contribution (\$, millions)	After Rates Volume (millions)
1	174.1%	6,249	73,651
2	174.6%	6,392	73,389
3	175.0%	6,497	72,752
4	175.2%	6,723	73,608
5	174.5%	6,957	75,365
6	174.6%	7,188	76,227
7	174.6%	7,355	76,432
8	174.4%	7,577	77,404

D. Determining Optimal Pricing Paths within Christensen Associates-type Models.

Valpak's Scenario 3 clearly provides the Postal Service with a higher contribution than Scenario 1. However, Valpak also would emphasize that even Scenario 3 does not provide a pricing path that optimizes contribution for the Postal Service under the Christensen Associates model. The limited time available for these comments precluded such an effort. However, a few principles can be identified that might be useful for such an effort.

First, when there is **no divergence** in autonomous secular rates of change, as in Christensen Associates' model "c," nothing is gained, and much is lost, by restraining price increases on Standard Flats.

Second, when there is a **significant divergence** — *e.g.*, when Standard Flats is subject to an autonomous secular decline which far exceeds any secular change in All Other — then given the parameters of Christensen Associates' model, increasing the price of underwater Flats too fast and too far can reduce contribution, as asserted by Christensen Associates and as its Version 1a illustrates.

Third, if the secular trend causes Standard Flats volume to decline around 8 percent per year, then a **price increase of around 2 to 3 percent above the CPI cap** would be indicated. However, if the secular decline is less, say 4 to 5 percent, then a much larger price increase, at least as much as **5 to 6 percent above CPI**, would be close to optimal for Postal Service contribution.

Using the Christensen Associates model and its assumptions, including the secular decline in the volume of Standard Flats, it might be possible to establish an even more

profitable path for volume decline and pricing that yields an even slightly higher contribution than Valpak Scenario 3. And, more generally, it also might be possible to establish a systematic method for optimizing contribution for variations of the models presented in USPS-LR-FY12-43, or for similar models with a price cap and divergent autonomous secular trends. Christensen Associates suggests that the optimal pricing of Standard Flats depends on the net divergence in secular trends (*see* Table IV-5, column 4). Basing price changes on the net divergence is one possible approach to optimization. However, time did not permit further investigation or tweaking of the Christensen Associates model. Rather, Valpak focused on developing a significantly more sophisticated model that could be used to separately analyze all six Standard Mail products to enable contribution maximization from Standard Mail.⁵⁹ *See* section V, *infra*.

⁵⁹ The Valpak Contribution Maximizing Model was referenced in Valpak's Comments in Docket No. R2013-1 (Nov. 1, 2012), p. 33, n.34 ("Valpak is developing a model from which one could develop optimal prices, and in the future would like to share its workpapers with the Commission or the Postal Service."). An early version of this model was provided to the Postal Service on November 20, 2012, just after the Docket No. R2013-1 Standard Mail prices were disapproved and remanded on November 16, 2012.

Table IV-4**Using the Christensen Associates Model to Identify a Superior Price Path to Higher Contribution**

<u>Year</u> (1)	<u>Assumed Secular Trend Flats (%)</u> (2)	<u>Scenario 3 Standard Flats Price Premium Over CPI (%)</u> (3)
1	-8.7	3.00
2	-8.7	2.00
3	-8.0	2.50
4	-6.0	3.50
5	-4.0	8.00
6	-3.0	4.50
7	-3.0	4.50
8	-2.0	6.00

Table IV-5**Using the Christensen Associates Model to Identify a Superior Price Path to Higher Contribution**

<u>Year</u> (1)	<u>Assumed Secular Trend Standard Flats (%)</u> (2)	<u>Assumed Secular Trend All Other (%)</u> (3)	<u>Divergence (%)</u> (4)
1	-8.7	-0.5	-9.2
2	-8.7	-0.5	-9.2
3	-8.0	-1.0	-9.0
4	-6.0	+1.0	-5.0
5	-4.0	+2.0	-2.0
6	-3.0	+1.0	-2.0
7	-3.0	0.0	-3.0
8	-2.0	+1.0	-1.0

E. Conclusions to Be Drawn from the Christensen Associates Study.

Contrary to the purpose for which it was offered, **from** the Postal Service's **Christensen Associates study** we can draw two conclusions:

First, that the Postal Service should **now** increase Standard Flat prices by **at least 3.0 percent over CPI**.

Second, if the annual decline in volume from the catalog industry on account of autonomous factors falls below 8.7 percent, the Postal Service should use its pricing flexibility to increase the price of Standard Flats **even further** so as to maintain an annual rate of decline of **at least 10 percent**, to jettison the highly unprofitable share of these pieces, at least until coverage of Flats is well in excess of 100 percent.

These conclusions are consistent with the financial realities faced by the Postal Service. By any standard, the Postal Service is in serious financial difficulty, and the Postal Service should focus on solving its own problems rather than in misusing its monopoly pricing powers to promote a selected group of for-profit companies such as cataloguers. The Postal Service is an agency of the federal government, and must view itself and act as a fiduciary for the taxpayer. Someday the Postal Service may look to taxpayers to bail it out. As a matter of (i) statute, (ii) Commission remedial order, (iii) basic economics, and (iv) sound public policy, the Postal Service should put priority on its own financial health. Its duty to advertisers is to provide not subsidies, but a level playing field, and stop playing favorites among various types of advertisers. The Postal Service must let the catalog industry fend for itself, just as it does with all other advertisers that rely on the mail.

The Valpak study, discussed in section V, *infra*, incorporates more real-world factors than the Christensen Associates study. And the Valpak study is much more useful than the Christensen Associates study in (i) helping the Commission evaluate the legitimacy of the reasons advanced in this docket by the Postal Service for resisting compliance with the Commission's remedial order concerning Standard Flats, and (ii) guiding the fashioning of a new remedial order in this docket, as well as (iii) guiding future pricing policy of the Postal Service, if it truly wants to focus on maximizing contribution rather than playing favorites and picking winners among users of Standard Mail.

V. THE VALPAK STANDARD MAIL CONTRIBUTION MODEL CONFIRMS THE ILLEGITIMACY OF THE POSTAL SERVICE RATIONALE FOR REFUSING TO IMPOSE ABOVE-AVERAGE INCREASES ON STANDARD FLATS AND ALLOWS THE COMMISSION TO ANALYZE THE EFFECT OF PRICE ADJUSTMENTS ON CONTRIBUTION.

Since enactment of PAEA, recurring, cumulative losses on underwater products have totaled more than \$7.5 billion. *See* Table II-2, *supra*. The Postal Service rationale for underpricing money-losing Standard Flats is demonstrated to be unreliable in Section IV, *supra*. While the problem of the Periodicals class is outside the Postal Service's ability to remedy completely on its own, the same is not true for Standard Flats. Moreover, the Postal Service has imposed counterintuitive price increases which result in, by far, the highest coverages within Standard Mail, on the two products with the highest elasticity — High Density/Saturation Letters and High Density/Saturation Flats & Parcels. The Postal Service has never demonstrated that it knows how to price Standard Mail products to maximize contribution.

Indeed, the price cap applies at the class level, giving the Postal Service considerable pricing flexibility at the product level. However, the Postal Service has never before presented a pricing model designed to maximize contribution from any class of mail. The Christensen Associates model disclaims any effort to maximize contribution, stating that “these are not models of optimal pricing paths.” Christensen Associates Report, p. 2. Instead, the sole purpose of its model is a “risk analysis,” designed to defend the Postal Service’s continued countenance of losses on Flats. *Id.*, p. 2.

The Christensen Associates model illustrates that, if the volume of Standard Flats is declining autonomously — *i.e.*, independent of elasticity in response to price changes — then raising its price in an attempt to increase contribution can be frustrated, as least partially, by lost volume and inefficient allocation of the price cap. While Christensen Associates makes a valid hypothetical point,⁶⁰ it does not provide a guide to pricing as it fails to address either:

- **How much** of an increase in the price of Standard Flats is too much, vis-a-vis maximizing contribution? and
- When striving to have Standard Flats coverage exceed 100 percent, **how fast** is too fast for annual price increases?

Valpak was unaware of the Christiansen Associates risk analysis model until the Postal Service filed its ACR, but the Postal Service was aware that Valpak was working on a true contribution maximizing model some time ago.⁶¹ An early version of this model was provided to the Postal Service on November 20, 2012, just after the Docket No. R2013-1 Standard Mail

⁶⁰ For a discussion of how the point raised by Christensen Associates can be accommodated within the Valpak model, *see* section V.H, *infra*.

⁶¹ *See* n.59, *supra*.

prices were disapproved and remanded on November 16, 2013. Although the Postal Service obviously never used the Valpak model when it submitted its revised prices (when it increased prices for Standard Flats by 2.617 percent⁶²), it was hoped that the Valpak model could help the Postal Service improve contribution and reduce some of its financial distress.

Valpak's model is offered here for two purposes: first, to further demonstrate the baselessness of the Postal Service's rationale for refusing to give meaningful above-average price increases to Standard Flats, and second, to demonstrate that the Postal Service's pricing for High Density/Saturation Letters is counter-productive and illegal.

A. The Challenge to Determining Maximum Contribution Available under the CPI Price Cap.

The cumulative amount by which total revenue can increase from price adjustments to the different pricing elements is constrained by the CPI price cap at the class level.⁶³ Thus, the Postal Service can allocate its pricing authority within the class by making tradeoffs in use of allowable cap space among products within the class.⁶⁴

⁶² A nominal 0.048 percentage points over the average of 2.569 percent.

⁶³ While the price increase for a product is a weighted average increase for each of the individual pricing elements, the remainder of this discussion will ignore pricing of individual elements to avoid unnecessary complexity. The average revenue from each product is considered here to be a reasonable proxy for the price of a product.

⁶⁴ The price structure for individual products within each class of mail typically contains a number of individual pricing elements — *e.g.*, a per-piece rate, a pound rate, discounts, surcharges, etc. Except for flat-rate Priority Mail parcels and single-piece First-Class letters, the general tariff schedule, in conjunction with mailing requirements, can be quite complex. A recent study by the USPS OIG has suggested that considerable simplification of both the tariff schedule and mailing requirements might help improve volume and profitability. See OIG Study Postal Service Pricing Strategy: Audit Report (Dec. 9, 2011), Report No. CI-AR-002, http://www.uspsoid.gov/foia_files/CI-AR-12-002.pdf.

For ease of exposition, this discussion will ignore the possibility of price reductions for any product. However, the principles developed could also be applied to price reductions.

The challenge faced by the Postal Service is to determine a set of price adjustments that will: (i) maximize the total additional contribution from all the products within each class, while (ii) not exceeding the price cap.⁶⁵ The result, when determined, can be described as the **unconstrained maximum contribution** available under the price cap, and the Valpak model seeks to identify those product price changes which lead to an **optimal** set of prices for Standard Mail, improving the Postal Service's bottom line.

The unconstrained maximum contribution is also useful in that it provides a **benchmark** to help evaluate the cost of the imposition of any pricing constraint — such as a desire to financially subsidize for-profit catalog mailers. The estimated reduction in contribution below the unconstrained maximum contribution can be considered the cost of imposing the constraint. At this point, the description of the Valpak model ignores secular trends of the type considered by Christensen Associates. Such trends can be readily included in the analysis, however. *See*

⁶⁵ A product's contribution is generally defined as the difference between revenue and attributable cost, where attributable cost excludes fixed costs and is essentially synonymous with volume variable costs. In the most recent rate adjustment docket, Docket No. R2013-1, the Postal Service remarkably, and perhaps for the first time, claimed that it is not appropriate to rely on the existing costing system when making price adjustments:

Though [a decline in volume] would not pose a significant problem if processing costs were perfectly correlated to volume, this is simply not the case. Given the **fixed nature of processing equipment** and the **inflexibility of union contracts**, processing costs would fall less quickly than volumes. [Docket No. R2013-1, Notice, p. 22 (emphasis added).]

Allegations concerning possible deficiencies in the inapplicability of the costing system used for price adjustments should be raised by the Postal Service in a separate rulemaking docket, not in the context of a rate adjustment docket or an annual compliance review. Until this is done, attributable costs should be expected to vary with volume.

section V.H, *infra*. Since the Postal Service could become insolvent later in this fiscal year, accountability to all concerned stakeholders, including taxpayers and Congress, should require that it explain and justify fully any deliberate reduction in contribution that is not mandated by law.⁶⁶

B. The Price Cap Defines a Limit to the Additional Revenue Allowed from Price Adjustments.

When the Postal Service makes its annual price adjustment, the percentage increase in revenue for each class of mail cannot exceed the price cap. An adjusted price — *i.e.*, the new price — is the old price plus the adjustment; thus,

$$\text{New price} = P_i + \Delta P_i ,$$

where

P_i = the existing price of product i , and

ΔP_i = the proposed adjustment (increase) in the price of product i .

Total revenue, R , estimated for product i from the proposed price change is the newly increased price times the volume in the Base Year period:

$$(1) \quad R_i = (P_i + \Delta P_i) \bullet V_i$$

where

R_i = revenue from product i , and

V_i = volume of product i in the most recent Base Year.

⁶⁶ In Docket No. R2013-1, the Postal Service commented that it intended to constrain the differential between the price of Standard Flats and Carrier Route. The Postal Service admitted that such a constraint is not a statutory mandate, but rather arbitrary. *See* Order No. 1541, pp. 44-45. To this day, the Postal Service offered no explanation for proposing such a constraint.

Revenue for the entire class is computed as the sum of revenue for all n products in the class, *i.e.*,

$$(2) \quad R = \sum (P_i + \Delta P_i) \bullet V_i$$

New revenue is divided by last year's revenue and is subtracted from 1 to get the percentage increase for the entire class of mail from the proposed price adjustments, ΔP_i . The resulting percentage should not exceed the CPI price cap, *i.e.*,

$$(3) \quad \left[\frac{\sum_{i=1}^n (P_i + \Delta P_i) \bullet V_i}{\sum_{i=1}^n (P_i) \bullet V_i} \right] - 1 \leq \text{price cap.}$$

With a little algebra, equation (3) can be written as:

$$(4) \quad \sum_{i=1}^n \Delta P_i \bullet V_i \leq \sum_{i=1}^n (P_i) \bullet V_i \bullet \text{price cap.}$$

The term on the left-hand side of equation (4) is the sum of the change in the price of each product multiplied by the volume of each respective product during the Base Period (*i.e.*, it is cumulative additional revenue from proposed price changes based on the most recent historic volume). The term on the right-hand side of equation (4) is the CPI price cap times last year's total revenue in the class (the sum of the price of each product multiplied by that product's volume).⁶⁷ Except for previously unutilized authority, it is the maximum "allowable revenue" that the Postal Service can raise in the current year from price increases to existing

⁶⁷ The Postal Service has referred to this maximum allowable revenue as its "precious cap space." Docket No. R2013-1, Notice, p. 23.

products.⁶⁸ To illustrate, if last year's total revenue from all products in a class were \$15 billion, and the price cap were 2.0 percent, the maximum allowable revenue would be \$300 million, and cumulative revenues from price changes for all products in the class could not exceed \$300 million.

The computation to ascertain conformance with the price cap does not take into account any effect of price changes on volume. In all preceding equations, the V_i are historical volumes as recorded in the most recent Base Period. Thus, elasticity plays no role when assessing compliance of proposed price changes with the price cap. The formula used to determine compliance with the price cap is neither forward looking, nor a projection, and excludes any price-induced effects on mail volume and contribution. The actual revenue realized from price adjustments almost certainly will differ from — and often may be less than — allowable revenue.

C. Maximum Allowable Revenue Defines a Multi-Dimensional Pricing Frontier with an Almost Unlimited Number of Possible Price Adjustments.

For any permitted percentage increase in prices — *e.g.*, 2.0 percent — a large number of different individual price adjustment contributions exist that would exactly utilize all of the increase in allowable revenue.⁶⁹ Collectively, the totality of possible price adjustments that

⁶⁸ In Docket No. R2013-1, the Postal Service for the first time proposed an increase in the maximum allowable revenue to take account of planned promotions that entail discounts and rebates to mailers. The Postal Service stated that “[t]he dollar value of the promotions, for purposes of the Standard Mail price cap compliance calculation, is estimated to be \$19.5 million.” Docket No. R2013-1, Notice, p. 27.

⁶⁹ The Postal Service frequently has proposed price increases that do not differ greatly from across-the-board percentage increases on all products within a class. Such a price increase, however, may fail to maximize the potentially available contribution, possibly by a

would provide the maximum increase in allowable revenue represents a multi-dimensional “maximum pricing frontier.” Any point on this frontier represents one particular set of price changes that produce the maximum increase in revenue allowed by the price cap.⁷⁰

Movement in any direction along this multi-dimensional maximum pricing frontier involves tradeoffs in prices and allowable revenue for each product. That is, increasing the price and revenue from one product requires that the price and revenue from other products in the class be decreased by an appropriate corresponding dollar amount.⁷¹ Somewhat less obvious are the changes that occur with respect to mail volume and contribution when moving along the maximum pricing frontier.

To illustrate, suppose the price cap is 2.0 percent, and the Postal Service were to begin its price adjustment exercise with an across-the-board increase of 2.0 percent — one possible point on the maximum pricing frontier. Then, to increase the price and revenue of, say, product A by more than 2.0 percent, the price and allowable revenue of one or more other products in the class (B, C, etc.) must be reduced by an appropriate amount designed to offset

wide margin.

⁷⁰ The pricing frontier is a convex set. Any price adjustment “**interior**” to this frontier would leave money on the table, *i.e.*, produce less than the full amount of the revenue allowed by the price cap. Any price adjustment “**exterior**” to this frontier would exceed the price cap and, ignoring any possible carryover from prior price adjustments, not be permissible.

⁷¹ The converse is also true. That is, if the price and revenue from one product were to be **decreased**, in order to stay on the frontier of maximum allowable revenue the price and revenue from some other products then may be **increased** appropriately.

exactly the extra allowable revenue obtained from increasing the price of product A above 2.0 percent.

Of course, not all points on the maximum pricing frontier will generate the same contribution. The actual contribution realized from any set of price adjustments will be affected by the profit margin on each product. Actual contribution is also affected by elasticity (*i.e.*, price-induced changes in volume), although movement along the frontier from one set of feasible price changes to another is determined only by allowable revenue, and does not reflect elasticity. For the Base Year, each product has its own total revenue, total cost, contribution, volume, and elasticity of demand. To the extent that the Postal Service wants to increase, or even maximize, contribution, the challenge facing the Postal Service is how to:

- Go directly to the point on this frontier that represents the maximum contribution, or else
- Move along this frontier in an iterative manner that will lead systematically to the maximum contribution, given the price cap and any other self-imposed possible constraints.⁷²

D. Tradeoff Schedules for Additional Contribution per Dollar of Allowable Revenue Enable an Iterative Solution.

All additional revenue from a price increase on any one product counts towards the maximum allowable revenue for the class of which it is a part. At the same time, the various products within a class have different coverages and elasticities. With respect to profitable

⁷² A possible constraint in any given year for the Postal Service might be a desire to avoid “price shock” by restricting price increases to, say, no more than three times the price cap. *See, e.g.*, 39 U.S.C. § 3622(b)(2) and (c)(3). Thus, if the price cap is 2.0 percent, then no price adjustment exceeding 6.0 percent would be considered for that year, even if doing so would further increase total contribution from the proposed price adjustment. For an illustration, *see* section G.7, *infra*.

products, for example, the contribution that can be extracted from each incremental increase in price (and utilization of allowable revenue) declines, with the extent of the decrement of profitable volume determined by elasticity of demand.

In order to maximize additional contribution from the annual price adjustment, one way to proceed is to construct for each product a schedule showing the additional contribution per dollar of allowable revenue that can be expected to result from each unit price increase.⁷³ This schedule needs to incorporate and reflect the elasticity for each product. For the various products within a class of mail, these schedules reflect tradeoffs between (i) utilization of allowable revenue, and (ii) the additional contribution associated with each dollar of allowable revenue.

When expressed as “contribution per dollar of allowable revenue,” the data in each schedule can be compared on an “apples-to-apples” basis,⁷⁴ and will be referred to here as “tradeoff schedules.” In general, each tradeoff schedule is unique, both as to the product and the year for which it is applicable. (For more detailed discussion, as well as examples, that demonstrate how to construct and utilize tradeoff schedules for the major products in Standard Mail, *see* section G.4, *infra*, and Appendix A.)

⁷³ For products in Standard Mail, pricing elements change in increments of \$0.001. The price of a product is a weighted average of the various pricing elements, and that weighted average can change almost continuously, *i.e.*, by amounts much smaller than \$0.001.

⁷⁴ It would appear that the Postal Service has not even bothered to compute the relevant tradeoff schedules. (If they had, PAEA’s goal of increased transparency in ratemaking has not been achieved.) Consequently, any effort by the Postal Service to maximize contribution within Standard Mail has failed and failed badly, losing cumulative billions of dollars.

E. Using Tradeoff Schedules to Determine Price Changes that Will Maximize Contribution.

Once all the relevant tradeoff schedules are developed, maximum unconstrained contribution requires that, as between the various products, when allowable revenue is at the cap, the additional contribution per dollar of allowable revenue from each product be equal at the margin. When (i) revenues from proposed changes in price are at the allowable cap, and (ii) a change in the unit price of each product results in the same increase in contribution per dollar of allowable revenue utilized, price adjustments can be said to be “Pareto optimal” vis-a-vis contribution. That is, Pareto optimality occurs when total contribution will not increase any further as a result of trading off (i) a unit price change in one product and the allowable revenue which accompanies that price change against (ii) an equivalent change in the price and allowable revenue of any other product.

If prices are adjusted in the manner just described so as to achieve a Pareto optimal result, contribution for the forthcoming fiscal year will be optimized. This is the **unconstrained maximum contribution** available under the price cap, as discussed above. Computing the unconstrained maximum contribution provides a useful benchmark for estimating the reduction in contribution caused by imposition of any constraints. Deviation below this benchmark also can be used when assessing compliance with section 3622(b)(5). (Section G.6, *infra*, gives an example demonstrating how to determine maximum unconstrained contribution using an iterative procedure with tradeoff schedules. How to determine the maximum contribution when an arbitrary constraint is imposed is illustrated in section G.7, *infra*.)

F. Maximizing Contribution over a Time Horizon Longer than One Year.⁷⁵

A change in the price of a product will affect volumes and contribution that are reflected, at least in theory, in the product's estimated elasticity. Costs also are dynamic, subject to macroeconomic forces outside control of the Postal Service. The various parameters such as elasticity and cost that are critical to compilation of tradeoff schedules can and will vary from one year to the next. Therefore, for any particular product, and from one year to the next, the tradeoff schedules can be expected to change. Percentage price changes that maximize contribution one year should not be expected to maximize contribution in the following year. This means that, if prices are adjusted annually, recalculation (or recalibration) of tradeoff schedules should be an annual exercise.

PAEA applies the price cap to each class of mail individually. In the absence of any documented interdependencies between the various classes of mail, maximization of contribution within each class of mail will maximize the Postal Service's total contribution. Normally, the Postal Service is best served by adjusting prices so as to maximize contribution within each class of mail for the forthcoming year. However, if maximization of contribution for one or more classes of mail over a longer period is to be considered, analysis over a multi-period model is necessary.⁷⁶

⁷⁵ In Docket No. R2013-1, and again in USPS-FY12-LR-43 in this docket, the Postal Service submitted multi-year models that purported to demonstrate longer-term effects on contribution of price changes to Standard Flats and Letters. That discussion, however, offered no framework for comparing the different streams of profits in the different models.

⁷⁶ In Docket No. R2013-1, after its one-period Standard Mail Contribution Model was shown to be highly flawed, the Postal Service said "pricing requires a long-run perspective. To focus on every price filing as a discrete and one-year event (as Valpak does in

Over multiple time periods 1 through n , the total cumulative contribution, or operating profits (TP), from a class of mail can be defined as:

$$(5) \quad TP = (R_1 - C_1) + (R_2 - C_2) + \dots + (R_n - C_n)$$

where

R = Revenues for the entire class in period i , and

C = Attributable Costs for the entire class in period i .

At the simplest level, equation (5) can be viewed as a tautology. It simply says that for a class of mail, total profits over some extended period will be the sum of profits earned in each successive period. Within the context of the Postal Service, one or even two years is not normally perceived to be a “long-run” period. So let us assume that in equation (5) each period is one year, and n is equal to 5, 10, or 15 years — whatever the Postal Service considers the normal planning horizon to be. Equation (5) then says that operating profits for the next n years will be the sum of operating profits over the indicated number of years.

Since the present value of a dollar of operating profits this year is worth more than a dollar of profits in later years, to put operating profits on an equal footing for comparability, projected profits must be discounted by an appropriate rate (price).

Equation (5) can be augmented to show the Discounted Present Value of Operating Profits (“DPVP”) by introducing an appropriate discount price, r , into the denominator as shown in equation (6):

its proposed contribution model) runs the risk of severely miscalculating the impacts of pricing decisions in the long-run.” Postal Service Reply Comments, p. 4 (Nov. 9, 2012).

$$(6) \quad DPVP = \frac{R_1 - C_1}{(1 + r)} + \frac{R_2 - C_2}{(1 + r)^2} + \dots + \frac{R_n - C_n}{(1 + r)^n}$$

where r is the discount price and, as before, the subscripts and superscripts indicate the period.

If the discount price r corresponds to the internal price of return used by the Postal Service for investment decisions, equation (5) is still somewhat tautological. We can use equation (5), however, to discuss long-run profit maximization.

Short-run profit maximization assumes that the Postal Service's objective is to maximize contribution during the year covered by the price adjustment. Within each class of mail, maximizing contribution from one year to the next usually will maximize longer-run contribution, provided that no significant **inter-temporal interdependencies** exist.⁷⁷ Many corporations experience and need to be aware of such interdependencies. However, it has not been demonstrated that the Postal Service is subject to significant inter-temporal interdependencies. If maximizing next year's contribution without regard to subsequent years is not considered appropriate for either the entire Postal Service or for any class of mail, then those responsible for running the Postal Service should maximize the discounted present value of the future stream of total contribution, which is shown as DPVP in equation (6).

Comparing next year's contribution (or contribution over the next two or three years) to some undiscounted stream of contribution over different future time periods is not an apples-to-

⁷⁷ This somewhat pedantic term, "inter-temporal interdependencies," means that costs incurred or revenues received in one period have significant interdependency with costs or revenues in one or more subsequent periods. R&D is one example of such a cost, *e.g.*, for some companies R&D in the current period can significantly affect revenues in subsequent periods. Although any underlying secular trend may affect future costs or revenues (if continued), not all are examples of inter-temporal interdependency.

apples comparison. For that reason, it is not sufficient for a stream of undiscounted operating profits weighted toward future years to just equal (or even slightly exceed) another stream weighted more heavily toward the next two or three years. For a proper economic comparison, one must compare the discounted present value of both streams of future profits.

G. A Model and Hypothetical for Demonstrating a Procedure to Determine Maximum Available Contribution under a Price Cap

Appendix A contains the Valpak Standard Mail Contribution Model, as well as a hypothetical that demonstrates how to determine the maximum contribution available under any given price cap and known initial conditions.⁷⁸ All references hereafter are to spreadsheets and tables contained in Appendix A.

The model uses an iterative procedure to develop the maximum contribution available from all products in a class of mail when a price cap limits the increase in revenue from the class. Wherever the model calls for historical data, data from the most recent fiscal year, FY 2012, are presented.

1. Base Period Data.

The first step is to assemble for the 12-month Base Period all the relevant data for every product in the class. The hypothetical in Table 1 under Tab “Max.Contribution” uses

⁷⁸ The Postal Service’s Standard Mail Contribution Model in USPS-LR-FY12-43 includes only two “products,” Flats and All Other Standard Mail (“Other”). Unlike that model, the Valpak Standard Mail Contribution Model separately analyzes each of the six products in Standard Mail.

Base Year data from the FY 2012 Cost and Revenue Analysis (“CRA”) Report.⁷⁹ In addition to the CRA data, the product elasticities submitted on January 22, 2013 are included.

By the time of the next notice of price adjustment (October 2013, presumably), the CRA data will be slightly different, consisting of the preceding four quarters — *i.e.*, inclusive of FY12Q4 and FY13Q1-3. (However, the January 22, 2013 estimate of elasticities will not have changed.)

2. Ascertain the CPI Price Cap.

The CPI price cap is used to compute the allowable revenue; multiply the total Base Period revenue for the entire class by the price cap. As the price cap for the price adjustment likely to be filed in October 2013 cannot be known at this time, this hypothetical arbitrarily assumes a price cap of 2.000 percent. Using this assumed price cap, computation of allowable revenue is shown beneath Table 1, under tab “Max.Contribution.” In the hypothetical here, the Base Period revenue is \$16.455 billion, and allowable revenue is \$329.120 million. To keep this hypothetical simple and focused on the procedure to determine the maximum contribution, the computation of allowable revenue here excludes other revenue that might be eligible for inclusion — *e.g.*, unutilized prior authority under the cap, revenue from special promotions, NSAs, fees, etc.

⁷⁹ If the Base Period is for a 12-month period other than one fiscal year, quarterly data from two fiscal years must be assembled.

3. A Model for Assessing Change in Contribution from Price Adjustments.

A model that incorporates changes in price, accompanying changes in volume and contribution, and utilization of allowable revenue is shown in Table 2 under tab “Max.Contribution.” The model includes all six major products in Standard Mail, but excludes NSAs. In Table 2:

Column 1 is the average revenue in the Base Period for each product. Average revenue is a weighted average of all the product’s different pricing elements, and in this hypothetical it is a proxy for price of the product.

Column 2 shows proposed adjustments in price. As the procedure for determining maximum contribution is an iterative process, various price adjustments will be entered in Column 2 until the all allowable revenue is utilized, and maximum contribution is determined.

Column 3, shows the new price for each product, and is the sum of the existing price plus the change in price.

Column 4 shows the percentage change in price, *i.e.*, column 2 divided by column 1.

Column 5 replicates the Base Period unit attributable cost for each product.

Column 6 shows the projected unit contribution — *i.e.*, average revenue at the new price less unit attributable cost.

Column 7 shows coverage based on the new price and the unit attributable cost (columns 3 and 5, respectively).

Column 8 replicates the Base Period volume for each product.

Column 9 shows the projected change in volume on account of (i) the change in price (column 2), and (ii) the product’s elasticity.

Column 10 computes the new volume.

Column 11 computes total revenue at the new volume, *i.e.*, the new price multiplied by the new volume (columns 3 and 10, respectively).

Column 12 computes the new total cost: the existing unit cost multiplied by the new volume (columns 5 and 10, respectively).

Column 13 is the total contribution expected from each product, *i.e.*, total revenue less total cost (columns 11 and 12, respectively). The expected increase in contribution from the new prices and new volumes is the new total contribution less total contribution in the Base Period. As the procedure for determining maximum contribution is an iterative process, it is helpful to display under this column here the change in contribution, as different sets of prices are entered in column 2.

Columns 14 and 15 show the change in revenue from the change in price (using Base Period volume).

Column 16 shows the utilization of allowable revenue.

Through various iterations of price adjustments, it is critical that utilization of allowable revenue be adjusted to stay at the maximum level determined under preceding subsection 2, *supra* (here \$329.120 million).

4. Compute Tradeoff Schedules that Show Marginal Changes in Contribution per Dollar of Allowable Revenue.

To help make the methodology transparent, individual tradeoff schedules are computed and displayed in column 10 of Tables 3-8 under each respective product tab. First, compute the increase in allowable revenue utilized by each unit increase in price (column 1 under each product tab). This is a straightforward computation: multiply Base Period volume by each unit increase in price.⁸⁰

⁸⁰ For simplicity and uniformity, all tradeoff schedules in Appendix A have been developed **up to a price increase of \$0.075** because the unconstrained maximum contribution required that large an increase for NFM/Parcels product. However, because utilization of allowable revenue in column 1 exceeds the maximum allowable revenue, the balance of the tradeoff schedule is somewhat academic.

Next, for each unit price increase at the left, the percentage increase in price is shown in column 2.

Using the price elasticity shown above column 3, the price-induced decline in volume for each unit price increase is shown in column 3. Column 4 then computes the estimated decline in volume (*i.e.*, Base Period volume above column 1 times the percent change in volume in column 3). The new volume that can be expected from each increment in price (Base Period volume less the price-induced decline in volume in column 4) is shown in column 5.

Expected total revenue at each increment of price and new volume is shown in column 6. The total cost for each of the new volumes is computed in column 7. The additional contribution expected at each price increment (*i.e.*, total revenue minus total cost) is shown in column 8.

The marginal increase in contribution for each unit increment in price is shown in column 9. As can be observed readily from Tables 3-8 under each respective product tab, marginal contribution is a declining function. Finally, the marginal increment in contribution is divided by the utilization of allowable revenue. The result, shown in column 10, is a tradeoff schedule showing the increase in contribution for each dollar of allowable revenue which that product utilizes from each marginal increment in price. The tradeoff schedules are also declining functions.

Allowable revenue defines what the Postal Service has called its “precious cap space,” and this “contribution per dollar of allowable revenue” might be thought of as “bang for the buck.” To maximize contribution, products that give the greatest contribution per dollar of

allowable revenue should receive marginal price increases, until some other product offers more contribution from a marginal increase in price. Tradeoff schedules computed according to the procedure described here will be declining functions, which means that tradeoffs between different products must be made incrementally at the margin, not across the board.

For ease of comparison, the tradeoff schedules for all products are shown in Table 9 under the tab Tradeoff Comparisons. In this hypothetical, based on the most recent data, Flats clearly give the greatest contribution per dollar of initial price increase, followed by NFMs/Parcels, while the two High Density/Saturation products give the least increase in contribution per dollar of initial price increase.

If the Postal Service previously had reached a point where contribution from the various products in a class of mail was maximized, then in successive years, relative changes in price in response to changes in the underlying data (*e.g.*, volume, elasticity, cost) likely would be small. That is, barring major changes in underlying data, prices would be “tweaked,” and percentage price increases likely would be somewhat similar for most products. However, when one (or more) products is underwater — *e.g.*, unit attributable cost exceeds average revenue — as is the case with Standard Flats and NFMs/Parcels, reduction in volume of these underwater products gives an unusually high “bang for the buck” because losses are reduced on volume that leaves (which helps increase net contribution), while revenue and contribution increase from volume that remains.

As an observation, the higher the elasticity of demand for any product, the greater will be the reduction in volume in response to an increase in price. When a product is underwater

(*e.g.*, Standard Flats), an assumption that the product has a higher elasticity would cause all amounts shown in the tradeoff schedule to increase.⁸¹

5. Procedure for Determining Maximum Contribution Obtainable under the Cap.

Once all tradeoff schedules have been computed, the procedure to determine the maximum revenue obtainable under the price cap, although iterative, is moderately straightforward. (All column references in this section here are to Table 2 under tab “Max. Contribution” in Appendix A, which is utilized.)

Incremental price adjustments are made in column 2 until total utilization of allowable revenue in column 16 reaches the cap, as determined in section G.2, *supra*. This initial set of prices gets to the frontier of maximum allowable revenue. One can begin with any such set of price adjustments and then move along this frontier by trading off increments in price adjustments for those products with the highest marginal contribution per dollar of allowable revenue and, concurrently, making offsetting reductions in the price adjustment of those products with the lowest contribution per dollar of allowable revenue. This iterative process continues until all possible tradeoffs that might improve contribution have been exhausted.

A considerable reduction in the potential number of steps in the iterative process just described is possible. Initial price increments should be focused on those products which yield

⁸¹ To demonstrate this effect, one could increase the elasticity for Standard Flats from -0.437 to, say, -0.704 in Table 1, cell J13 under tab Contribution, and observe the changes in the Standard Flats tradeoff schedule in either Table 7 or Table 9. In Docket No. R2013-1, the Postal Service narrative implied that it believed the response of Standard Flats volume to be more sensitive (*i.e.*, more elastic) to a price increase than the computed elasticity.

the highest contribution per dollar of allowable revenue, until the first price increment from some other product gives a higher marginal contribution.

Once the “maximum contribution available” under the price cap has been determined, any imposition of various constraints (adjustments) that reduce the maximum contribution can be measured and evaluated against their cost in terms of reduction in potential contribution.

(See section G.7, *infra*, for an illustration.)

6. Maximum Contribution in This Hypothetical.

In this hypothetical, the maximum contribution is obtained when the price adjustments are focused solely on (i) Standard Flats and (ii) NFMs/Parcels. The price adjustments for Standard Flats and for NFMs/Parcels that maximize contribution are, respectively, \$0.05163 and \$0.07400.⁸² As a percentage, increases for these two products are, respectively, 13.754 and 7.886 percent.⁸³ Utilization of allowable revenue is \$329.120 million, which is 100 percent of the maximum. These prices produce a maximum unconstrained increase in contribution of \$342.448 million. At the respective price increases of \$0.05163 and \$0.07400, each product yields approximately \$0.982 of incremental contribution, as can be seen from their respective tradeoff schedules in Table 9 under tab Tradeoffs Compared.⁸⁴

⁸² Pricing elements are quoted to the nearest tenth of a cent. By “tweaking” individual pricing elements, adjustments to average revenue can change by amounts smaller than one-tenth of a cent.

⁸³ The price differential between Standard Flats and Carrier Route widens, as that differential is considered here to be unconstrained.

⁸⁴ The maximum contribution (\$342.448 million) exceeds the allowable revenue (\$329.120 million) because Flats and NFMs/Parcels are both underwater products. When no product is underwater, allowable revenue can be expected to exceed the unconstrained

It should be noted that the model here incorporates no autonomous exogenous trends for any products. This implicit “assumption” accords generally with version “c” in the Christensen Associates model (USPS-FY12-LR-43), which shows that, in the absence of divergent trends (including no trend), the Postal Service gains contribution from increasing the price of Standard Flats. (*See* Section V.H, *infra*, for instructions on how to deal with divergent trends in this model.)

7. Maximum Contribution in this Hypothetical with an Additional Restriction.

To further illustrate use of the tradeoff schedules, assume that, for whatever reason, it is arbitrarily decided to cap the price increase on Standard Flats at 1.05 percent times the CPI cap (assumed to be 2.000 assumed in this hypothetical).²⁶ For simplicity, assume that this same limit is placed on the price adjustment for NFMs/Parcels. This new restriction would mean that, in this hypothetical, no price increase on Standard Flats or NFMs/Parcels should exceed 2.10 percent. Since the above price adjustments for Standard Flats and NFMs/Parcels both exceed this new constraint, their price adjustments would be restricted as follows:

Product	Average Revenue	2.10% Increase	Adjusted Price
Flats	\$0.375	\$0.008	\$0.383
NFMs/Parcels	\$0.938	\$0.020	\$0.958

Two salient questions then become:

maximum contribution.

²⁶ This cap on Standard Flats price increases is the same as the Postal Service’s proposed schedule of future price increases. *See* FY 2012 ACR, p. 19.

- How to maximize contribution subject to constraints such as the limit on price adjustments here for Standard Flats and NFMs/Parcels?
- By how much is contribution reduced from the unconstrained maximum (of \$342.448 million)?

When the above increases for Standard Flats and NFMs/Parcels are entered in column 2 of Table 2 (with all other prices set to equal zero), only \$52.803 million of allowable revenue is utilized, *i.e.*, at this point unutilized allowable revenue amounts to \$276.317 million. Since the adjusted price for Standard Flats and NFMs/Parcels is now capped arbitrarily, the products with the next highest marginal contribution are Letters and Carrier Route. The marginal contribution per dollar of allowable revenue is quite similar for each of these two products. Because Letters has very high volume, and Carrier Route has moderately high volume, relatively small price adjustments for these two products utilize all the remaining allowable revenue before tradeoffs from upward price adjustments on the other two products become favorable (*see* Table 9 under tab Tradeoffs Compared). Increasing the price of Carrier Route by \$0.0049965 and Letters by \$0.00500 (respectively, 2.030 and 2.570 percent) brings utilization of allowable revenue up to \$329.120 million, which is just equal to the maximum allowable revenue in this hypothetical; *see* Table 2 under tab “ConstrainedMaxCont.” At a price increment of \$0.0049965 for Carrier Route and \$0.00500 for Letters, the marginal contribution per dollar of allowable revenue for each of these two products is \$0.777 (*see* Table 9 under tab Tradeoffs Compared). The tradeoff between Letters and Carrier Route at the preceding price increments versus the first price increment for Saturation and High Density Letters and Flats is unfavorable, and contribution would be reduced further if the price

increase on either Carrier Route or Letters were tempered to enable some price increase on the two Saturation products.

Assuming that the Postal Service were to opt for the “second-best” constrained maximum pricing adjustment just described, the arbitrary constraint on price adjustments for Standard Flats and NFMs/Parcels is seen to reduce contribution from the maximum unconstrained amount of \$342.448 million to \$274.803 million. The reduction in contribution, \$67.645 million, or 19.75 percent, is of course a mere trifle compared to the cumulative billions that the Postal Service already has lost on Standard Flats. Nevertheless, as the Commission is responsible for seeing that Postal Service pricing complies with law, which requires the Postal Service “to assure adequate revenue, including retained earnings, to maintain financial stability” (39 U.S.C. § 3622(b)(5)), the Commission needs to take notice of what the Postal Service has heretofore ignored.

H. Comparison with Christensen Associates’ Multi-Period, Divergent-Trend Model.

The Valpak model incorporates the most recent price elasticities for each Standard Mail product, as developed by the Postal Service in its submission of January 22, 2013. Otherwise, the model here contains no assumption regarding autonomous secular trends (independent of elasticity-induced price changes) affecting volume of any product.

If one were to assume an autonomous secular trend of **equal** magnitude affecting all products, as in version “c” of the model by Christensen Associates, the model here would be generally applicable over multiple time periods. If, however, one were to assume **divergent**

autonomous trends, as in version “a” of the model by Christensen Associates, some adjustments to the model here would be needed.

Before describing the appropriate adjustments, a cautionary note is in order. It would not be correct to link mechanically one period to the next, as Christensen Associates does in the different versions of its model. Even if parameters such as elasticities, inflation, and costs are assumed not to change from one year to the next (similar to assumptions made in Christensen Associates’ model “a”), then, as indicated previously, the tradeoff schedules need to be re-calibrated before each annual price adjustment in order to reflect the most recent changes in volumes.

If divergent volume trends exist, or are assumed, tradeoff schedules should be adjusted to reflect the extent of expected secular change. For a simple illustration of the requisite adjustment, assume that Standard Flats volume is declining autonomously at a rate of 8.0 percent per year, and that no other Standard Mail products are subject to an autonomous secular trend, either up or down. Under this circumstance, the appropriate adjustment would be to multiply $1.00 - 0.08$ (0.92) times the base year volume for Flats used to generate the tradeoff schedule (tab Flats, cell B11).²⁷ That adjustment reduces the contribution per dollar of allowable revenue to reflect the fact that, as the price cap is used up, the marginal contribution for each unit of price adjustment is applicable to only 92 percent of the volume. Using this

²⁷ If a product has a positive growth trend, the adjustment (*i.e.*, the multiplier) would exceed 1.0. Note that the Base Year volume of Flats in Table 2 (cells E13 and I42) does not change.

adjusted tradeoff schedule, one then proceeds to determine price adjustments that maximize contribution, as before.

The preceding procedure can be used to illustrate that a sufficiently large divergence in volume trends could reduce, or even eliminate, any net gain in contribution from Standard Flats, as Christensen Associates hypothesizes.²⁸ For the year (or years) when a sufficiently large divergence is assumed, the problem of underwater is seen to “fix itself.” However, the secular decline in Standard Flats would have to be quite large to bring the marginal gain in contribution from Standard Flats below the marginal gain from the two products with the next highest marginal gain in contribution.²⁹ Using the tradeoff schedules as developed in Table 9 under tab “Tradeoffs Compared,” **the secular decline in Standard Flats volume would have to exceed -19.0 percent** for this to occur. If the secular decline in Standard Flats is less than this amount, the initial marginal contribution from increasing the price of Standard Flats still will exceed the marginal contribution from Carrier Route and Letters.

²⁸ To illustrate its hypothesis, Christensen Associates proffers a hypothetical in which all volume of a product is assumed to “disappear” after being allotted some of the Postal Service’s precious cap space. In the context of the Valpak model, one could hypothesize (or assume) that, say, half of all Standard Flats volume is going to disappear next year. Such an assumption would require multiplying the tradeoff schedule for Flats by 0.5. After such a reduction, all other products would have a higher marginal contribution per dollar of allowable revenue, which would call for price increases on every other product before imposing any price increase on Standard Flats. This illustrates that, within limits, the Christensen Associates hypothesis has a point.

²⁹ In this hypothetical, the product with the next highest contribution per dollar of allowable revenue utilized is Letters, if Parcels/NFMs, which now has a very small volume, is excluded.

I. Conclusion.

The Valpak Standard Mail Contribution Maximization model is thus shown to be superior to the Christensen Associates risk analysis model for use in making pricing decisions in many respects. Based on the Valpak model, it is urged that the Commission: Determine that the Postal Service has not demonstrated that the above-average increases in Standard Flats prices which it ordered in Docket No. ACR2010 would be counterproductive, as the Postal Service has claimed to justify its disobedience with the Commission's remedial order.

VI. **POSTAL SERVICE STANDARD MAIL PRODUCT PRICING IS NEITHER BASED ON ELASTICITY, NOR CONTENT, NOR CHANGES IN COST, NOR ANY LEGITIMATE REASON, AND HIGH DENSITY/SATURATION LETTER PRICING VIOLATES PAEA.**

A. **The Postal Service Does Not Employ Demand-Based Pricing.**

Historically, both the Postal Service and the Commission took into account the elasticity of demand in setting prices for products. The importance of elasticity of demand is currently reflected in 39 U.S.C. section 3622(c)(3) ("the effect of rate increases") and Commission Rules, which require that:

[b]y January 20 of each year, the Postal Service shall provide econometric estimates of **demand elasticity for all postal products** accompanied by the underlying econometric models and the input data sets used; and a **volume forecast** for the current fiscal year, and the underlying volume forecasting model. [39 C.F.R. § 3050.26 (emphasis added).]

Own-price elasticity measures the degree to which demand for a product is responsive to changes in price for that product. It is measured as the percentage change in quantity demanded in response to a 1 percent change in price.³⁰ In the world of postal products, discussion generally relates to price increases, not decreases. Products for which demand is highly responsive to increases in prices are said to have highly “elastic” demand. Products for which demand remains fairly constant in the face of moderate price increases are said to have relatively “inelastic” demand.

The most recent (i) January 2013 estimates³¹ of price elasticity for all market dominant products are set out in Table VI-1, along with estimates previously submitted (ii) in January 2012, which were the elasticity estimates available to the Postal Service at the time its last price adjustments were noticed, and (iii) in January 2011 as well, for comparison purposes.³² The former Standard ECR subclass, which includes three Standard Mail products (High Density/Saturation Letters, High Density/Saturation Flats & Parcels, and Carrier Route), had a relatively consistent estimated elasticity of **0.727** in January 2011, **0.782** in January 2012, and **0.704** in January 2013 (row 7). In 2013, of all computed elasticities, the former ECR subclass

³⁰ Since price increases almost always lead to reduced demand, price elasticities technically are negative numbers, but generally are stated as absolute values.

³¹ http://www.prc.gov/Docs/79/79839/MDM_20120120165520.pdf

³² See Demand Analyses submitted to the Commission January 20, 2012 and January 20, 2011. In certain instances, elasticities are estimated only for former subclasses, or groups of products — *e.g.*, Standard Regular Mail or Standard ECR — not for individual products within Standard Mail.

continues to be near the top of the list, only behind two much smaller parcel products — Media/Library Mail and Bound Printed Matter.³³

Table VI-1
Own-Price Elasticity of Market Dominant Products
(Absolute value)

	January 2011	January 2012	January 2013
1. First-Class Single-Piece letters	0.182	0.189	0.276
2. First-Class Presort letters	0.346	0.436	0.392
3. First-Class Single-Piece cards	0.249	0.063	0.276
4. First-Class Presort cards	1.397	0.292	0.392
5. Periodicals	0.133	0.122	0.126
6. Standard Regular Mail	0.286	0.335	0.437
7. Standard ECR Mail	0.727	0.782	0.704
8. Standard Nonprofit Mail	0.177	0.265	0.299
9. Standard Nonprofit ECR	0.513	0.542	0.560
10. Parcel Post	0.389	0.366	0.373
11. Bound Printed Matter	0.719	0.774	0.772
12. Media/Library Mail	0.847	0.832	0.969

Sources: Demand Analysis submitted to the Commission on January 20, 2011, January 20, 2012, and January 22, 2013.

Since PAEA, the Postal Service has expressed its desire to use its pricing flexibility to engage in demand-based pricing.³⁴ However, if the Postal Service actually based product

³³ In FY 2012, Standard Mail volume was 79.8 billion, compared with Bound Printed Mail (Flats and Parcels) at 474 million, and Media/Library Mail at 100 million. *See* FY 2010 ACR, pp. 14, 29.

³⁴ *See, e.g.,* USPS Fact Sheet on Pricing, March 2, 2010 (“Prices for mailing products (Market Dominant) should be based on demand for individual products and their costs....”) <http://about.usps.com/news/electronic-press-kits/delivering-future/dtf-FSpricing.pdf>

prices on demand, it would be expected to impose higher price increases on products with lower elasticity, and lower price increases on products with higher elasticity. Yet in Docket No. R2013-1, the Postal Service implemented price increases for Standard Mail on January 27, 2013, as shown in Table VI-2, *infra*. The Postal Service's price changes were all within a relatively narrow band around the class-wide average of 2.569 percent.

Table IV-2
Standard Mail Product Price Changes of Jan. 27, 2013
by Former Subclass

<u>Product</u>	<u>Price Change</u> (%)	<u>Commercial</u> <u>Elasticity</u>
Former Regular Subclass:		
Standard Letters	2.610	0.437
Standard Flats	2.617	0.437
Standard Parcels/NFMs	3.081	0.437
Former ECR Subclass:		
HD/Sat Letters	2.059	0.704
HD/Sat Flats and Parcels	2.092	0.704
Carrier Route	2.907	0.704
Average Standard Mail	2.569	

Source: Docket No. R2013-1, Order No. 1573;³⁵ Elasticity from Postal Service filing with Commission on January 22, 2013.

Comparing the two flats products which do not include parcels in Standard Mail, the Postal Service's most recent price adjustments impose a **larger percentage increase** on the

³⁵ See Docket No. R2013-1: Postal Service Notice of Standard Mail Product Price Changes (Oct. 11, 2012), p. 19 <http://www.prc.gov/Docs/85/85334/Notice%20Package.pdf>; Commission Order (No. 1541) on Price Adjustments for Market Dominant Products and Related Mail Classification Changes (Nov. 16, 2012), p. 25 http://www.prc.gov/Docs/85/85662/Order_1541.pdf; and Commission Order (No. 1573) on Standard Mail Rate Adjustments and Related Mail Classification Changes (Dec. 11, 2012), p. 3.

more **profitable product** with the **higher elasticity**, Carrier Route, than on Standard Flats, the deeply underwater product with a lower elasticity. Such pricing decisions do not fall within any meaningful description of “demand-based,” and no rationale explaining non-demand-based pricing decisions is offered. Although management is said to “view prices, price changes, and pricing structures as aspects of mail products and a pricing strategy as one element of a wider product goal,”³⁶ that wider product goal has not been given meaningful enunciation as it relates to Standard Mail.

Moreover, the price changes on January 27, 2013 are not aberrational. Looking beyond price increases imposed in any one year, one can compare the share of institutional costs that products with high elasticity are asked to pay versus the share that products with low elasticity are asked to pay. Although demand-based pricing would tend to impose a greater share of institutional costs on products with low elasticity of demand, the reverse appears to be true with respect to Standard Mail, as seen in Table VI-5, discussed in section VI.C, *infra*. An analysis based on cost coverage within Standard Mail certainly does not demonstrate that pricing over the years has been demand-based.

B. The Postal Service Does Not Base Prices on Costs.

With the change from the PRA to PAEA, it was said that the Postal Service was freed from the shackles of cost-based pricing. Of course, it is far from irrational to base prices on costs. Part of the reason for good costing is to know how to price products — giving the

³⁶ USPS OIG, Postal Service Pricing Strategy Audit Report (Dec. 9, 2011), p. 6, http://www.uspsoig.gov/foia_files/ci-ar-12-002.pdf.

proper price signals to the market, to encourage the use of efficient products, and discourage the use of inefficient — and money-losing — products.

Under PAEA, the first year that the Postal Service reported data on a product basis was FY 2008. It is interesting to examine how Standard Mail costs and unit revenues have changed during this period. Table VI-3 shows changes in unit cost, and Table VI-4 shows changes in unit revenue. Two observations jump off these tables.

First, **all Standard Mail products showed increases in unit cost except one — High Density/Saturation Letters** — which, over a **five-year** period, showed a **reduction** in costs of 1.6 percent. Nevertheless, under Postal Service pricing, **unit revenues** from this product used by Valpak **increased twice as fast as Standard Flats**. This absurd pricing resulted in the cost coverage of Saturation Flats decreasing from **94.1 percent** in FY 2008 to **80.7 percent** in FY 2012, while the cost coverage of High Density/Saturation Letters used by Valpak increased from **208.9 percent** to **221.0 percent**.

Second, as contrasted with that 1.6 percent decrease in unit costs of High Density/Saturation letters, the unit cost of High Density/Saturation Flats & Parcels increased 26.7 percent. Nevertheless, under Postal Service pricing, **unit revenues** from the product used by Valpak **increased faster than High Density/Saturation Flats & Parcels**. This also absurd pricing resulted in the cost coverage of High Density/Saturation Flats & Parcels, decreasing from an admittedly excessive **265.4 percent** in FY 2008 to **216.8 percent** in FY 2012, while the cost coverage of High Density/Saturation Letters used by Valpak increased from **208.9 percent** to now exceed High Density/Saturation Flats & Parcels at **221.0 percent**. Such is the

Postal Service's reward to High Density/Saturation Letter mailers for preparing and entering the most efficient mail the Postal Service handles.

Rather than giving meaningful price signals which would lead to societal efficiency, the Postal Service has given mailers perverse price signals, encouraging mailers to enter higher cost and lower profit (or even negative profit) loss-causing mail.

Table VI-3
Standard Mail Product Unit Cost Changes FY 2008 to FY 2012
by Former Subclass

<u>Product</u>	<u>FY 2008</u> \$	<u>FY 2012</u> \$	<u>Change</u> %
Former Regular Subclass:			
Standard Letters	0.096	0.109	13.5
Standard Flats	0.389	0.465	19.5
Standard Parcels/NFMs	1.109	1.113	0.4
Former ECR Subclass:			
HD/Sat Letters	0.063	0.062	-1.6
HD/Sat Flats and Parcels	0.060	0.076	26.7
Carrier Route	0.151	0.189	25.2

Source: FY 2008 ACR, p. 22; FY 2012 ACR, p. 14.

Table VI-4
Standard Mail Product Unit Revenue Changes FY 2008 to FY 2012
by Former Subclass

<u>Product</u>	<u>FY 2008</u> \$	<u>FY 2012</u> \$	<u>Change</u> %
Former Regular Subclass:			
Standard Letters	0.185	0.195	5.4
Standard Flats	0.366	0.375	2.5
Standard Parcels/NFMs	0.882	0.938	6.3
Former ECR Subclass:			
HD/Sat Letters	0.131	0.138	5.3
HD/Sat Flats and Parcels	0.159	0.166	4.4
Carrier Route	0.226	0.246	8.8

Source: FY 2008 ACR, p. 22; FY 2012 ACR, p. 14.

C. The Postal Service Pricing Does Not Seek to Normalize Standard Mail Cost Coverage over the Six Advertising Mail Products.

If the Postal Service does not base pricing on demand or on costs, could it be attempting to normalize cost coverage across Standard Mail, as all users of Standard Mail are advertisers? This pricing policy would tend to impose on the same type of mail a similar institutional cost burden.

Table VI-5 shows coverages of Standard Mail products alongside their subclass elasticity. Of the six products within Standard Mail, revenues from two products with the lowest elasticity did not even cover their attributable cost, as Standard Flats and Regular NFMs/Parcels were substantially underwater. In FY 2012, the underwater portion of the attributable cost of these two products had to be subsidized from operating profits earned on other Standard Mail products — particularly High Density/Saturation Letters and High Density/Saturation Flats & Parcels.

Table VI-5
Standard Mail Product Cost Coverages and Elasticities
by Former Subclass

<u>Product</u>	<u>Cost Coverage</u>	<u>Commercial Elasticity</u>
Former Regular Subclass:		
Regular Letters	177.9%	0.437
Regular Flats	80.7%	0.437
Regular NFM/Parcels	84.3%	0.437
Former ECR Subclass:		
HD/Sat Letters	221.0%	0.704
HD/Sat Flats/Parcels	216.8%	0.704
Carrier Route	130.4%	0.704
Standard Class Weighted Average	149.0%	

Source: Coverages from FY 2012 ACR, Table 2, p. 14; Elasticities from Table VI-2, *supra*.

All Standard Mail is similar in terms of content: largely advertising mail. The average coverage for the class is **149.0 percent**. Yet the two high-elasticity saturation products had coverages completely disproportionate to the other products, well over 200 percent: High Density/Saturation Letters (**221.0 percent**) and High Density/Saturation Flats & Parcels (**216.8 percent**). The coverage spread between (i) High Density/Saturation Letters and (ii) Standard Flats is approaching three-to-one.

The Postal Service's excessive coverage for High Density/Saturation Letters cannot be explained by either the elasticity, cost, or content of the mail.

D. Postal Service Pricing Is Not a Sophisticated Effort of Pricing Flexibility, but Simply Subsidizes Certain Catalog Mailers, while Giving near Across-the-Board Increases to Others.

The Postal Service's ACR claims that the Governors' pricing decisions are sophisticated undertakings, requiring the Governors to consider many factors such as:

- (i) "anticipated market conditions" FY 2012 ACR, p. 16;
- (ii) "evaluation of market and business strategy concerns" *Id.*;
- (iii) "financial risk" *Id.* p. 17;
- (iv) "ability to react to changing market and strategy considerations" *Id.* p. 18; and
- (v) "constantly changing market and strategic factors" USPS Response to ChIR No. 4, question 1a.

If there were so many factors that required "thoughtful balancing in the hands of the Governors" (*id.*, p. 19), then one would expect that price adjustments for various products within Standard Mail would show significant differences — but this is rarely the case. As seen in Table VI-6, for example, in the January 27, 2013 price product adjustments, two products were virtually at the average, and average increases for the other four products clustered closely around the average, with no Standard Mail product deviating by more than a nominal 0.512 percent. The overriding policy consideration that seems to drive most Standard Mail pricing is the desire to financially favor catalog advertisers with underwater pricing, thereby requiring other Standard Mail advertising products to pay more than they should, resulting in a cross-subsidy.

Table VI-6
Standard Mail Product Price Adjustments of Jan. 27, 2013
by Former Subclass

Product	<u>Price Change</u> (%)	<u>Variation</u> <u>from Average</u>
Former Regular Subclass:		
Standard Letters	2.610	0.041
Standard Flats	2.617	0.048
Standard Parcels/NFMs	3.081	0.512
Former ECR Subclass:		
HD/Sat Letters	2.059	0.510
HD/Sat Flats and Parcels	2.092	0.477
Carrier Route	2.907	0.338
Average Standard Mail	2.569	

Source: Docket No. R2013-1, Order No. 1573

The Postal Service is playing favorites, picking winners and losers among advertising mailers, and creating a most un-level playing field — totally contrary to an appropriate role for a government agency.

E. Pricing for High Density/Saturation Letters Is Illegal under PAEA.

Valpak continues to object strenuously to excessively high coverage for High Density/Saturation Letters. This is certainly not the first year that Valpak has raised these objections. *See* Docket No. ACR2007, Valpak Comments,³⁷ pp. 39-40; Docket No.

³⁷

http://www.prc.gov/Docs/58/58756/Valpak_ACR2007_Initial_Comments.pdf.

ACR2008, Valpak Comments,³⁸ pp. 43-58; Docket No. ACR2009, Valpak Comments,³⁹ pp. 44-49; Docket No. ACR2010, Valpak Comments,⁴⁰ pp. 54-71; and Docket No. ACR2011, Valpak Comments, pp. 27-39.⁴¹

Although the Commission did not directly address the issue in Docket No. ACR2007⁴² and Docket No. ACR2008,⁴³ the Commission briefly commented on Valpak's argument in Docket No. ACR2009:

In its comments, Valpak argues for a “significant reduction in the coverage of High-Density/Saturation products.” Valpak Comments at 49. Valpak states that categories with relatively elastic demand should have relatively low cost coverages and thus pricing of High Density and Saturation products is not optimal.

In Docket No. R2009-2, the Postal Service gave **below average increases** to High Density and Saturation Letters (1.248 percent) and High Density and Saturation Flats/Parcels (2.233 percent). The Postal Service explained that the below average increases were **in recognition of the market characteristics** of these products. Thus, it appears the Postal Service has attempted

³⁸ <http://www.prc.gov/Docs/62/62024/VP%20ACR2008%20Initial%20Comments.pdf>

³⁹ <http://www.prc.gov/Docs/66/66609/VP%20ACR2009%20Initial%20Comments.pdf>

⁴⁰ <http://www.prc.gov/Docs/71/71786/Valpak%20ACR2010%20Initial%20Comments.pdf>

⁴¹ <http://www.prc.gov/Docs/80/80280/VP%20ACR2011%20Initial%20Comments.pdf>

⁴² <http://www.prc.gov/Docs/59/59460/ACR2007Report.pdf>

⁴³ http://www.prc.gov/Docs/62/62784/ACD%20Report_2008_FINAL.pdf

to be responsive to the concerns expressed by Valpak. [FY 2009 ACD, p. 87 (emphasis added).⁴⁴]

In Docket No. ACR2010, the Commission discussed the problem posed by High Density and Saturation Letters similarly:

In FY 2010, the High Density and Saturation Letters product had a cost coverage of 212.8 percent. It contributed \$393.0 million to the institutional cost of the Postal Service. Both the nonprofit and commercial components of the High Density and Saturation Letters product made a positive contribution to institutional cost. In its comments, **Valpak argues that “pricing and cost coverage on high density/saturation mail remain too high.”** Valpak Comments at 65. Valpak states that categories with relatively **elastic demand** should have relatively low cost coverages and thus pricing of High Density and Saturation products **is not optimal**. Valpak Comments at 65.

In Docket No. R2011-2, the Postal Service proposed **below average increases** to High Density and Saturation Letters (0.615 percent) and High Density and Saturation Flats/Parcels (0.403 percent). The Postal Service explained that the below average increases were in recognition of the market characteristics of these products. [FY 2010 ACD, p. 108 (emphasis added).]

In Docket No. ACR2011, the Commission addressed High Density and Saturation Letters as follows:

In FY 2011, the High Density and Saturation Letters product had a cost coverage of 221.2 percent, and contributed 7.5 cents per piece to institutional costs. The product contributed a total of \$423.1 million to institutional costs, with commercial pieces contributing \$414.6 million and nonprofit pieces contributing \$8.6 million.

Valpak argues that no product should produce revenues that are greater than twice their attributable costs. Valpak Comments at 38. Valpak requests that the Commission “roll

back the most recent price increases.” Id. In light of some products with cost coverages below 100 percent, Valpak suggests that price increases on products with high elasticities and cost coverages over 200 percent be suspended until those products’ cost coverages are no longer above 200 percent. Id. High Density and Saturation Letters received an **above average price increase** in the Docket No. R2012-3 price adjustment, but **that fact alone does not warrant Commission action**. In general, the Postal Service is accorded pricing flexibility under title 39 to allow these kinds of pricing decisions. [FY 2011 ACD, p. 120 (emphasis added).]

Had Valpak’s legal complaint been based on “an above average price increase” and “that fact alone,” it could not disagree with the Commission’s decision that it “does not warrant Commission action.” However, the problem is much more serious, and Valpak would like to take this opportunity to clarify and enhance the basis for its request to the Commission, as well as to renew its request. Accordingly, Valpak requests the Commission to find that the coverage for High Density/Saturation Letters is too high, and should be lowered significantly, and soon. Valpak urges the Commission to find High Density/Saturation Letter pricing illegal, and to enter a remedial order to roll back the most recent price increases that were imposed on this product on January 27, 2013.⁴⁵

As has been demonstrated, *supra*, the Postal Service does **not** base Standard Mail pricing on demand factors as measured by **elasticity**. Second, the Postal Service does **not** base Standard Mail pricing on changes in **unit cost**. Third, it does not base Standard Mail pricing based on an effort to **normalize coverage** for all similar content advertising mail. Fourth, it

⁴⁵ See U.S. Postal Service Notice of Market-Dominant Price Adjustment (Oct. 18, 2011), p. 18 <http://www.prc.gov/Docs/76/76795/Notice%20of%20Rate%20Adjustment%20Final.pdf>.

appears that the Postal Service's pricing for Standard Mail begins with the desire to cross-subsidize Standard Flats, an objective which violates, *inter alia*, 39 U.S.C. section 101(d). The illegal cross-subsidy to Standard Flats has generally been made possible by imposing seemingly reasonable near across-the-board increases for other Standard mailers — yet having the effect of penalizing High Density/Saturation Letters, which is (i) the only product with **declining costs**, (ii) in the former ECR Subclass which demonstrates the **highest elasticity**, and yet (iii) has the **highest coverage** of any Standard Mail product. Certainly there is no justification for charging High Density/Saturation Letters prices which are more than twice their attributable costs, particularly when other mailers are paying less than their attributable costs. A near three-to-one coverage ratio with Standard prices is profoundly wrong.

While the Postal Service was given a measure of pricing flexibility, it does not have flexibility to violate PAEA's pricing standards. By any measure, Postal Service pricing Standard Mail in general and High Density/Saturation Letters in particular has been shown:

- (i) to be arbitrary and capricious, in violation of 39 U.S.C. section 3622;
- (ii) to fail to apportion the costs of Standard Mail fairly in violation of 39 U.S.C. section 101(d);
- (iii) to unfairly give an unjustified preference to Standard Flats in violation of 39 U.S.C. section 404(c); and
- (iv) to unfairly discriminate against High Density/Saturation Letters, in violation of 39 U.S.C. section 404(c).

Based on this, Valpak asks the Commission to make a finding that prices for High Density/Standard Letters and Standard Flats are not in compliance with PAEA and that,

Standard Flats prices be increased by a specific amount over CPI in the range of 5 percent over CPI, subject to reexamination in each annual compliance review, until Standard Flats revenues cover costs and make a reasonable contribution to institutional costs (*e.g.*, 120-130 percent), and allocating less price cap authority to High Density/Saturation Letters to lower that product's coverage. Further, such new pricing should be ordered to begin by requiring the Postal Service, within 60 days, to notice new Standard Mail prices, to go into effect within 180 days from January 27, 2013.

VII. THE PERIODICALS CLASS WAS NOT IN COMPLIANCE WITH LAW IN FY 2012 AND WILL CONTINUE TO HEMORRHAGE MONEY UNTIL THE COMMISSION ISSUES A REMEDIAL ORDER.

A. The Periodicals Class Is Hemorrhaging Money.

In FY 2012, the Postal Service lost more money than ever on the Periodicals class — **\$670.1 million** — with cost coverage dropping to its lowest level ever at **72.10 percent**. This FY 2012 loss is **up 10 percent** from \$608.9 million in FY 2011, and coverage is down from 74.94 percent in FY 2011. The FY 2012 Periodicals loss constitutes 14.4 percent of total FY 2012 Postal Service operating losses. Periodicals now has lost money in **16 consecutive years** since 1997, racking up a huge cumulative deficit: **\$5.6 billion**.

Table VII-1
Periodicals Class — Revenue, Cost, Coverage, and Cross-Subsidies
FY 1997 — 2012

	(1)	(2)	(3)	(4)
PRC CRA	Revenue	Costs	Cover- age	Revenue – Costs
Year	(\$, mill.)	(\$, mill.)		(\$, mill.)
Under PAEA				
2012	1,731.5	2,401.6	72.10%	-670.1
2011	1,821.1	2,430.0	74.94%	-608.9
2010	1,878.8	2,489.8	75.46%	-611.0
2009	2,038.0	2,680.0	76.04%	-642.0
2008	2,294.9	2,732.1	84.00%	-437.2
2007	2,187.9	2,635.6	83.01%	-447.7
Subtotal	11,952.2	15,369.1	77.77%	-3,416.9
Under PRA				
2006	2,124.8	2,487.6	85.42%	-362.8
2005	2,068.9	2,431.6	85.08%	-362.7
2004	2,100.0	2,323.3	90.39%	-223.3
2003	2,139.6	2,196.2	97.42%	-56.6
2002	2,066.9	2,280.4	90.64%	-213.5
2001	2,106.9	2,367.1	89.01%	-260.2
2000	2,076.3	2,354.8	88.17%	-278.5
1999	2,017.7	2,213.1	91.17%	-195.4
1998	1,972.8	2,129.0	92.66%	-156.2
1997	1,964.6	2,038.5	96.37%	-73.9
Subtotal	20,638.5	22,821.6	90.43%	-2,183.1
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TOTAL	32,590.7	38,190.7	85.34%	-5,600.0

Surprisingly, the Postal Service reports that Periodicals FY 2012 unit revenue remained the same as in FY 2011 (25.7 cents), despite the January 2012 price increase. FY 2012 ACR, p. 26. Unit costs were not flat, however, increasing from 34.3 cents to 35.6 cents. Table VII-2 shows that this trend of (i) relatively stable unit revenue and (ii) steadily increasing unit costs has been consistent under PAEA — not a good sign. Unit losses nearly doubled under PAEA, from **5.1 cents** per piece to **9.9 cents** per piece.

Table VII-2
Periodicals Unit Revenue and Costs under PAEA
FY 2007 – 2012

	Revenue per Piece	Costs per Piece	Contrib. per Piece
2007	0.249	0.300	-0.051
2008	0.265	0.317	-0.052
2009	0.256	0.337	-0.081
2010	0.258	0.343	-0.085
2011	0.257	0.343	-0.086
2012	0.257	0.356	-0.099

Among the most disturbing news about Periodicals in the FY 2012 ACR is that the Postal Service reports it has implemented all cost savings initiatives developed with the Commission in the Joint Periodicals Study issued in September 2011 (“*Periodicals Mail Study*”)⁴⁶:

These [cost coverage] declines have occurred **despite** the Postal Service **taking the steps outlined** in the *Periodicals Mail Study*.

⁴⁶ http://www.prc.gov/Docs/76/76767/Periodicals%20Mail%20Study_final_2131_2149.pdf.

* * *

While the Postal Service believes that some of the savings from those steps began to accrue in FY 2012, it is clear that they did not impact the cost coverage appreciably. Of course, some of the initiatives are longer-term than one year, and in some instances costs from the changes associated with those initiatives have been incurred while the associated savings may take longer to realize.

More generally, while the Postal Service will pursue whatever efficiency enhancements are possible, it is **extremely doubtful** that, in the context of price increases limited to the CPI cap, the Periodicals class can achieve **100 percent cost coverage**. [FY 2012 ACR, pp. 26-27 (emphasis added).]

Despite its admission that huge losses are occurring and will continue, the Postal Service seeks neither a finding of illegality nor a remedial order from the Commission in its ACR. It does not even ask the Commission to examine its own authority to remedy the problem as it did in the last two ACRs.

B. All Prior Rationales for Delay Have Been Rendered Moot.

FY 2007-2009 ACDs. In the first three ACDs, the Commission took no action on the problem of the Periodicals class failing to cover its costs, in each case relying largely on the anticipated release of the Joint Periodicals Study. *See* FY 2007 ACD, p. 70; FY 2008 ACD, pp. 58-59; FY 2009 ACD, p. 75.

Docket No. R2010-4. In the Postal Service's request for an exigent price adjustment in Docket No. R2010-4, it proposed increasing Periodicals prices by an average of 8.035 percent, well above the proposed average market dominant price increase of 5.6 percent, but this exigent filing was denied by the Commission.

FY 2010 ACD. The Postal Service recognized two years ago in its FY 2010 ACR that Periodicals would never achieve full cost coverage without above-CPI pricing:

With the Commission's denial of the Postal Service's exigent rate increase request in Docket No. R2010-4, the **Postal Service's plan** for bringing the fourteen products to full attributable cost coverage is **no longer workable**. The results contained in the present ACR show that the cost coverage problem continues to exist and remains systemic. As the Postal Service has **indicated to the Commission** over the course of their joint work on the **Periodical Study**, even if the Postal Service achieves the **most optimistic efficiency enhancements possible**, it does not foresee that such enhancements, combined with annual rate increases within the statutory price cap, will result in **Periodicals**, Standard Mail Flats, and Standard Mail NFM/Parcels reaching full attributable cost coverage. In other words, it seems **impossible** for the Postal Service, **acting with the powers granted** to it and within the constraints imposed by title 39, to present any realistic plan that would result in these products fully covering their attributable costs, much less making any contributions to institutional costs. Therefore, it seems most appropriate for the **Commission to determine** whether it can exercise any of its powers to remedy the cost coverage shortfall of the products in question. [FY 2010 ACR, pp. 7-8 (emphasis added).]

The Commission rejected the Postal Service's appeal to exercise its powers, instead (again) relying on the "forthcoming Periodicals Study Report" and "room for improvement in worksharing discounts and in the prices for bundles and containers." FY 2010 ACD, p. 94.

The Commission did not conclude that it had the authority to order above-cap increases for an entire class, stating that it simply "need not address the scope of remedial powers under section 3653," given that "management has not yet fully brought to bear efficiency enhancements, network adjustments, and related changes...." *Id.*, p. 17.

FY 2011 ACD. In Docket No. ACR2011, the Postal Service submitted reply comments renewing its earlier plea:

Further, with respect to correcting class level cost coverage shortfalls, the Postal Service repeats its statements from

Docket No. ACR2010 that the Postal Service **cannot**, with the tools that are available to it remedy the cost coverage shortfall of the Periodicals class. **Thus, the Postal Service again encourages the Commission to determine whether it has the authority under the PAEA to raise rates beyond the price cap.** Even if the Commission were to determine that it does not have this power, such a determination would clarify to Congress that, if Congress believes that the Commission should have the power to remedy class-level cost coverage shortfalls, Congress must explicitly grant the Commission such power. [Docket No. ACR2011, Postal Service Reply Comments, p. 7 (footnote omitted, emphasis added).]

In response to the Postal Service's renewed plea, the Commission once again declined to act, relying on the Joint Periodicals Study for the delay, and explained that the Postal Service was implementing the various actions identified in the Study and that "affording the Postal Service an opportunity to realize the new efficiencies is the appropriate course." FY 2011 ACD, p. 17.

FY 2012 ACR. Now, the Postal Service reports clearly and finally that, while cost savings "began to accrue in FY 2012, it is clear that they did not impact the cost coverage appreciably." FY 2012 ACR, p. 27. Not only did cost savings not impact cost coverage in a positive way, the serious additional declines "occurred despite the Postal Service taking the steps outlined in the *Periodicals Mail Study*." *Id.*, p. 26.

The evidence is now in. The Commission justify no further delay by relying on hypothetical future cost savings to restore Periodicals to full cost coverage. The Commission conceded this fact with the Joint Periodicals Study, which noted in October 2011 that, "Regardless of [cost savings estimates], there will still be a cost coverage gap; without price

changes or legislative changes, **Periodicals will not be able to cover its costs.**” *Periodicals Mail Study*, p. 91 (emphasis added).

In FY 2013, marginal cost savings could result from full deployment of the Flats Sequencing System (“FSS”), and some savings from the Mail Processing Network Rationalization in Docket No. N2012-1 could occur. However, both sources of potential savings are speculative and cannot be relied on. They fall in the same category of costs that the Commission addressed in Docket No. R2013-1, Order No. 1541, p. 37 (“The Commission shares NPPC’s concern about the Postal Service’s reliance on **unproven future cost savings** as justification for below-cost rates for Standard Mail Flats.” (Emphasis added.)) Likewise, these totally unproven and highly speculative future cost savings can no longer be used to justify continuation of prices for Periodicals that are deeply below cost.

The FSS investment has been particularly disappointing with respect to cost savings. Even if the Postal Service were able to increase the proportion of mail being processed on FSS, and decrease that which was being processed manually or otherwise, it would not be sufficient to move Periodicals appreciably towards complete cost coverage.⁴⁷ The Postal Service Inspector General recently reported that the percentage of all market dominant flat-shaped mail processed manually was 29.3 percent and that, if the Postal Service was able to reduce that amount to 20 percent, the Postal Service could possibly save \$129.6 million per year. USPS OIG, “Flat-Shaped Mail Costs: Audit Report,” Jan. 4, 2013, p. 3. But that potential savings is for all market dominant flat-shaped mail, and as Periodicals represents only 19.1 percent of flat

⁴⁷ See ChIR No. 5, question 24 (response due Feb. 6, 2013).

mail volume (in FY 2011) (*id.*, p. 1), it represents a speculative savings of only \$24.8 million per year. That constitutes less than 4 percent of Periodicals' \$670.1 million loss.

No doubt, the Postal Service will continue to take steps to attempt to reduce the attributable costs of Periodicals. Indeed, it must reduce costs for all classes of mail. But it is time the Commission moved beyond reliance on what it recently called "unproven future cost savings" and order steps consistent with law that will put the Postal Service back on a track, to reduce Periodicals losses and increase coverage.

C. The Commission Must Make a Finding of Noncompliance for Periodicals.

Valpak's Initial Comments in Docket No. ACR2011 analyzed the various objectives and factors of section 3622 as applied to Periodicals. *See* Docket No. ACR2011, Valpak Initial Comments, pp. 71-78. Valpak hereby incorporates those comments by reference, as they are fully applicable to this docket. For those reasons, and the reasons discussed herein, Valpak urges the Commission to find that Periodicals class pricing violates the section 3622(c)(2) **requirement that classes must cover their costs**. Also, Periodicals' prices in FY 2012 violated section 101(d), in that Periodicals does not share a fair and equitable portion of all postal costs.⁴⁸ Finally, the Postal Service violated section 403(c) by maintaining Periodicals' prices in FY 2012 so that they unduly and unreasonably discriminated against other mailers, who were forced to pay a higher cost coverage to cross-subsidize Periodicals.

⁴⁸ Periodicals' pricing also violates the last sentence of 39 U.S.C. section 101(a): "The costs of establishing and maintaining the Postal Service shall not be apportioned to impair the overall value of such service to the people," and are contrary to 39 U.S.C. section 3622(b)(5).

Last year, the Commission found that “Periodicals and Standard Flats face distinguishable circumstances” (FY 2011 ACD, p. 17), allowing a finding of violation for Standard Flats, but not for Periodicals. The Commission justified its inaction on Periodicals in the FY 2011 ACD on four grounds. None of these reasons is persuasive for FY 2012.

First, the Commission stated, “Periodicals had cost coverage shortfalls in the years prior to the passage of the PAEA.” *Id.* As demonstrated in Table VII-1 above, that is true. However, even if Congress wanted that inequity to continue at the same level, Table VII-1 also shows that the annual losses have accelerated (now approaching twice the loss as was incurred in FY 2006) while cost coverage has plummeted (dropping to 72.1 percent from 85.4 percent in FY 2006). Annual losses in the six years under PAEA are much worse than when PAEA was enacted and cumulatively have easily dwarfed the entire 10-year loss prior to PAEA. Permitting continued losses of this extent and duration is fiscally irresponsible. The Commission cannot and should not assume that Congress wanted Periodicals to be subsidized indefinitely and irrespective of the amount of the losses. Allowing such losses to continue unabated is completely inconsistent with the concept of a financially independent Postal Service supported by ratepayers.

Second, the Commission correctly concluded, “Periodicals as a class fails to cover costs, thus foreclosing a rebalancing pricing strategy,” but “there is no suggestion that the Postal Service has ignored its pricing flexibility under the PAEA with respect to the Periodicals products.” FY 2011 ACD, p. 17. (The Commission made this same point about pricing flexibility in its FY 2010 ACD (p. 17).) It is obvious that the Postal Service’s pricing flexibility has limited options when dealing with an underwater class that has only two

products, both of which are severely underwater. Indeed, adherence to the price cap has caused the ratemaking system to fail to provide pricing flexibility to the Postal Service as the objective under (b)(4) or the factor under (c)(7).⁴⁹ Of course, any inability of the Postal Service to act is all the more reason why the Commission must act. Failure to act would indict the whole pricing scheme under PAEA.

Third, the Commission stated that “management has not yet fully brought to bear ... changes which could alter the attributable cost picture for Periodicals.” FY 2011 ACD, p. 17. The Postal Service reports that declines in coverage “have occurred despite the Postal Service taking the steps outlined in the *Periodicals Mail Study*,” but regardless of some yet unrealized cost savings, “it is extremely doubtful that, in the context of price increases limited to the CPI cap, the Periodicals class can achieve 100 percent cost coverage.” FY 2012 ACR, pp. 26-27. This confirms the Periodicals Mail Study report that “without [above-cap] price changes or legislative changes, Periodicals will not be able to cover its costs.” Periodicals Mail Study, p. 91. The Postal Service identified the extensive operations changes it had undertaken, which impacted Periodicals costs, in FY 2012 in its Response to ChIR No. 1, Question 1, but the Postal Service was not able to “isolate the cost savings resulting from the ... initiatives.” Even if it could have done so, there were not sufficient savings to prevent

⁴⁹ It seems bizarre that the Postal Service adjusted Periodicals in Docket No. R2013-1 to leave unused 0.021 percentage points under the price cap. It is equally bizarre that the Postal Service did not use (perhaps allowing to expire — *see* 39 U.S.C. § 3622(d)(2)(C)(2) (unused price adjustment authority must be used within five years)) the unused pricing authority from Docket No. R2008-1 of 0.015 percentage points. In business, when one is losing money, every penny counts — but not at the Postal Service.

cost coverage from declining further. The Commission cannot reasonably rely on future additional cost savings to justify again failing to make a finding of noncompliance.

Fourth, “The Commission takes seriously the concerns that price increases on Periodicals may, as a consequence, drive periodical publishers out of the print business.”

FY 2011 ACD, p. 17. Naturally, no one wants to see jobs lost and diversity of opinion reduced, but periodicals publishers leaving the print business does not equate with periodicals publishers going out of business.⁵⁰ New media have expanded the scope, availability, and competition among publishers, and many publishers leaving the print business have managed to survive online only.

Encouragingly, the Commission hinted that an end might be in sight as “the persistent negative contribution from Periodicals **cannot endure indefinitely.**” FY 2011 ACD, p. 17 (emphasis added). Yet far less encouraging, the Commission indicated that it might kick the can well down the road another four years:

Because the Commission has **not** made a **finding of noncompliance** in this docket, the Commission does not need to comment on the appropriateness of Valpak’s suggested remedies. The Commission **will review** the suitability of the PAEA modern rate regulations and classes in **FY 2016** pursuant to section 3622(d)(3). [FY 2011 ACD, p. 106 (emphasis added).]

However, if the Commission does not act now to start resolving Periodicals and begin moving toward compliance, the Commission is helping to guarantee that the PAEA ratemaking system is a failure, incapable of achieving the objectives and factors set forth in PAEA. Commission

⁵⁰ See, e.g., “A Turn of the Page for Newsweek,” Oct. 18, 2012, <http://www.thedailybeast.com/articles/2012/10/18/a-turn-of-the-page-for-newsweek.html>.

passivity calls into question the utility of the Commission in a future postal system, as Congress continues deliberations of potential postal reform this year. If nothing else, the Commission needs to test the limit of existing legislation, before reinforcing the conclusion that it is incapable of rectifying the long-continued underwater status of the Periodicals class.

D. The Commission Has the Statutory Authority to Order Above-Cap Price Increases.

The Postal Service, to its credit, has worked to remove costs from the system, and unlike Standard Mail Flats, has twice sought — not fought — assistance from the Commission to resolve some of the pricing problem of Periodicals. At this point, because of the price cap and the Commission’s rejection of the exigent rate request, **only the Commission can order Periodicals price increases in excess of the cap.**

For the last two years, the Commission has gone to considerable lengths to avoid having to address the scope of its remedial authority by not finding Periodicals out of compliance. *See* FY 2011 ACD, p. 106; FY 2010 ACD, p. 17. For the reasons explained above, this year, Valpak asks the Commission to make a finding of illegality. Once the Commission makes a finding of noncompliance, it is then required to develop an appropriate remedy that will both “achieve compliance” and “remedy the effect of any noncompliance.” 39 U.S.C. § 3662(c). PAEA provides a non-exclusive list of examples of remedies that will achieve both of the elements of an appropriate remedial order, including (i) “ordering unlawful rates to be adjusted to lawful levels,” and (ii) “order[ing] the Postal Service to discontinue providing loss-making products.” *Id.*

Valpak urges the Commission to order Periodicals prices be increased in the range of CPI plus 5.0 percent annually, until Periodicals revenue exceeds costs and makes some contribution to institutional costs (*e.g.*, 105 percent coverage). Although an above cap increase is not permissible within the confines of a regular price adjustment under section 3622(d), the Commission is not so bound. PAEA provided the price cap generally to protect all mailers, but it also provided the compliance determination and complaint processes of sections 3652, 3653, and 3662.

Respectfully submitted,

William J. Olson
Jeremiah L. Morgan
John S. Miles
WILLIAM J. OLSON, P.C.
370 Maple Avenue West, Suite 4
Vienna, Virginia 22180-5615
(703) 356-5070

Counsel for:
Valpak Direct Marketing Systems, Inc. and
Valpak Dealers' Association, Inc.